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No. ____

IN THE

Supreme Court of the United States

OCTOBER TERM, 1983

THE PEOPLE OF THE STATE OF CALIFORNIA
AND THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA,

Petitioners,

v.

TENNECO OIL COMPANY, *et al.*,

Respondents.

APPENDIX

Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Fifth Circuit

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INDEX TO APPENDIX

1. Opinion of the Court of Appeals, *El Paso Natural Gas Co.* v. *Sun Oil Co.*, 708 F.2d 1011 (July 5, 1983) 1a-19a
2. Order of Federal Energy Regulatory Commission Affirming Initial Decision and Initiating Further Hearing, *El Paso Natural Gas Co.*, 12 FERC ¶ 61,297 (September 25, 1980) 21a-31a
3. ALJ's Initial Decision on Jurisdictional Status of Lease Sale Agreements, *El Paso Natural Gas Co.*, 6 FERC ¶ 63,037 (February 20, 1979) 33a-120a
4. Opinion of the United States District Court for the Western District of Texas, *El Paso Natural Gas Co.* v. *Sun Oil Co.*, 426 F. Supp. 963 (January 27, 1977) 121a-136a
5. Order of Court of Appeals, *Tenneco Oil Co.* v. *FERC*, 580 F.2d 722 (September 6, 1978) . 137a-141a
6. Order of the Court of Appeals, *Tenneco Oil Co.* v. *FERC* (October 25, 1978) 143a-144a
7. Judgment of the Court of Appeals, *Tenneco Oil Co.* v. *FERC*, No. 80-2404 (July 5, 1983) 145a
8. Judgment of the Court of Appeals, *Tenneco Oil Co.* v. *FERC*, No. 77-2613 (July 5, 1983) 147a
9. Judgment of the Court of Appeals, *El Paso Natural Gas Co.* v. *Sun Oil Company*, No. 77-1762 (July 5, 1983) 149a
10. Order of the Court of Appeals Denying Petition for Rehearing and Suggestion for Rehearing En Banc (December 2, 1983) 151a-152a
11. Order of Federal Energy Regulatory Commission Denying Applications for Rehearing, *El Paso Natural Gas Co.*, 13 FERC ¶ 61,239 (December 18, 1980) 153a-154a
12. Natural Gas Act, §§ 1(b), 2(6), 4(a), 7(c) 155a

1. OPINION OF THE COURT OF APPEALS, *EL PASO NATURAL GAS CO.* v. *SUN OIL CO.*, 708 F.2d 1011 (JULY 5, 1983)

UNITED STATES COURT OF APPEALS,
FIFTH CIRCUIT.*
July 5, 1983

Nos. 77-1762, 77-2613 and 80-2404

EL PASO NATURAL GAS COMPANY, *et al.*,
Plaintiffs-Appellants,

v.

SUN OIL COMPANY, *et al.*,
Defendants-Appellees.

TENNECO OIL CO., *et al.*,
Petitioners,

v.

FEDERAL ENERGY REGULATORY COMMISSION,
Respondent.

TENNECO OIL COMPANY, *et al.*,
Petitioners,

v.

FEDERAL ENERGY REGULATORY COMMISSION,
Respondent.

Petitions were filed seeking review of orders of the Federal Energy Regulatory Commission which determined that it had jurisdiction over certain lease-sale agreements transferring rights to certain gas-bearing lands in the San Juan Basin of New Mexico and Colorado. After consolidation with a decision of the United States District Court for the Western District of Texas, Dorwin W. Suttle, J., which found that such agreements were not within regulatory jurisdiction of the Commission, the Court of Appeals, Roney, Circuit Judge, held that where reserves underlying the leaseholds were not substantially developed at the time the lease sales were executed

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*Former Fifth Circuit case, Section 9(3) of Public Law 96-452, October 14, 1980.

because of lack of imminent ability to produce in commercial quanities, series of lease-sale agreements transferring rights to certain gas-bearing lands in the San Juan Basin of New Mexico were not sales of natural gas in interstate commerce within meaning of Natural Gas Act and were therefore beyond regulatory jurisdiction of Federal Energy Regulatory Commission.

Appeal from district court's decision affirmed; one petition for review dismissed and the other reversed.

Daniel Joseph, Jack W. Hanks, Daniel Watkiss, Washington, D.C., Donald C. Shepler, Salt Lake City, Utah, David K. Watkiss, Jack D. Bachman, Salt Lake City, Utah, for Northwest Pipeline Corp.

Rufus G. Thayer, Jr., Janice E. Kerr, J. Calvin Simpson, San Francisco, Cal., for People of State of Cal. and Public Utilities Com'n of State of California.

Howard V. Golub, Shirley A. Woo, Malcolm H. Furbush, San Francisco, Cal., for Pacific Gas & Elec. Co.

Charles F. Hawkins, Dallas, Tex., for Southern Union Co.

J. Alan Galbraith, Washington, D.C., Arthur R. Formanek, El Paso, Tex., for El Paso Natural Gas Co.

Steven A. Taube, Atty., George H. Williams, Jr., Jerome Nelson, Sol., Washington, D.C., for amicus curiae F.E.R.C.

Leo J. Hoffman, Herf M. Weinert, Julius L. Lybrand, Dallas, Tex., for Sun Oil Co.

George B. Mickum, III, Steven H. Brose, Washington, D.C., Edward J. Kremer, Jr., Dallas, Tex., for Atlantic Richfield Co.

Craig W. Hulvey, Washington, D.C., Robert D. Haworth, Houston, Tex., for Mobil Oil Corp.

Gordon Gooch, Charles M. Darling, IV, Washington, D.C., for Tenneco, Continental, American Petrofina, Crown Central, Delta Drilling, M/MS Morris Mizel.

Vernon M. Turner, Houston, Tex., for Tenneco.

Michael J. Henke, Washington, D.C., Dee H. Richardson, Midland, Tex., for Union Oil Co. of Cal.

Thomas Burton, Jr., Houston, Tex., for Continental Oil Co.

W.B. Browder, Jr., Midland, Tex., for W. Watson LaForce, et al.

Donald F. Burke, Baltimore, Md., for Crown Central Petroleum.

Terry R. Barrett, Stanley L. Cunningham, Oklahoma City, Okl., for F.H.N., Ltd.

Robert D. Haworth, Houston, Tex., for Mobil Oil Corp.

Craig W. Hulvey, Washington, D.C., for Getty Oil Co.

Sherman S. Poland, Bernard A. Foster, III, Ross, Marsh & Foster, Washington, D.C., for William G. Webb, et al.

J.O. Terrell Couch, Hutcheson & Grundy, Randel R. Young, Houston, Tex., for Robert Beamon, et al.

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Larry Pain, John L. Williford, Bartlesville, Okl., for Phillips Petroleum Co.

John S. Fick, Los Angeles, Cal., for Southern Cal. Gas Co.

William M. Lange, Colorado Springs, Colo., for Colo. Interstate Gas Co.

Robert H. Landt, Denver, Colo., for Amoco Production Co.

J. Alan Galbraith, Washington, D.C., for El Paso Natural Gas Co.

Donald K. Dankner, Washington, D.C., for CP National Corp.

Robert L. Simpson, Spokane, Wash., for Wash. Water Power Co.

G. Thomas Dohn, Yakima, Wash., for City of Ellensburg.

Justin R. Wolf, Washington, D.C., Bruce R. DeBolt, Associate Counsel, Portland, Or., for Northwest Natural Gas Co.

Thomas F. Brosnan, Washington, D.C., for Washington Natural Gas Co.

John H. Socolofsky, Asst. Atty. Gen., Salem, Or., for Public Utility Com'r of Oregon.

Kenneth O. Eikenberry, Atty. Gen., Donald D. Trotter, Asst. Atty. Gen., Olympia, Wash., for Washington Utilities and T nsportation Com'n.

John Ketcham, Washington, D.C., for Cascade Natural Gas Corp.

P. Michael Koenig, William M. Lange, Colorado Springs, Colo., for Colo. Interstate Gas Co.

Lester D. Sitter, Denver, Colo., for Rocky Mountain Natural Gas Co., Inc.

Gary G. Sackett, Associate Gen. Counsel, Salt Lake City, Utah, for Mountain Fuel Supply Co.

Steven R. Shanahan, Sr., Asst. Atty. Gen., Cheyenne, Wyo., for Public Service Com'n of Wyoming.

Zev E. Kaplan, Deputy Atty. Gen., Carson City, Nev., for Public Service Com'n of Nev.

J. Richard Tiano, Washington, D.C., for Intermountain Gas Co.

Wm. W. Bedwell, Washington, D.C., for Southwest Gas Corporation.

Michael S. Gilmore, Deputy Atty. Gen., Boise, Idaho, for Idaho Pub. Utilities Comm.

Appeal from the United States District Court for the Western District of Texas.

Petitions for Review of Orders of the Federal Energy Regulatory Commission.

Before BROWN, RONEY and TJOFLAT, Circuit Judges.

RONEY, Circuit Judge:

The basic question presented by these consolidated appeals is whether a series of lease-sale agreements transferring rights to certain gas-bearing lands in the San Juan Basin of New Mexico are sales of natural gas in interstate commerce within the meaning of section 1(b) of the Natural Gas Act, 15 U.S.C.A. § 717(b). Holding the agreements are not sales as defined by the Act, and are therefore beyond regulatory jurisdiction, we affirm the district court judgment to that effect and reverse the decision of the Federal Energy Regulatory Commission to the contrary.

Before considering a case of this kind, it is necessary to remind ourselves that the Commission's power to regulate the economics of natural gas transactions has been limited by Congress. Although it presumably has the power to regulate every nook and cranny of the natural gas business, Congress chose not to do so. *FPC* v. *Panhandle Eastern Pipe Line Co.*, 337 U.S. 498, 502, 69 S.Ct. 1251, 1254, 93 L.Ed. 1499 (1949). In this situation, it is important that the courts restrict the regulatory agencies to precisely that authority delivered to them by Congress, and to stop where Congress intended to stop no matter how tempting it might be to hearken to persuasive arguments that more regulation is appropriate. Agencies have a tendency to perceive a need for regulation. Congress is the determinative body in the matter, however, and this case has been considered and decided on that precise premise. If Congress had intended to regulate the transactions here involved, it easily could have done so with simple legislative language. We make no judgment whether it should have done so. We only decide, based upon the leading Supreme Court decision and the prior precedent of this Court, that it did not.

Before reviewing the facts and getting on with the decision, it might be helpful to describe the parties to this litigation while

footnoting the names of all litigants, to state briefly the source of these appeals and the lengthy history of the litigation, and in a simplified way to suggest the issues that have been presented for decision.

THE PARTIES

On one side of this litigation are two pipeline companies,[1] which acquired leasehold rights in gas-bearing lands, and the Federal Energy Regulation Commission. On the other side are numerous oil and gas concerns and a few individuals who transferred the leasehold rights in question.[2] A number of state commissions and interested private entities have been granted permission to intervene or file amicus briefs.[3]

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[1] El Paso Natural Gas Company and Northwest Pipeline Corporation.

[2] Sun Oil Company, Atlantic Richfield Company, Mobil Oil Corporation, Tenneco Oil Company, Continental Oil Company, American Petrofina Company of Texas, Union Oil Company of California, Crown Central Petroleum Corporation, Delta Drilling Company, Amoco Production Company, Phillips Petroleum Company, F.H.N., Ltd., Getty Oil Company, W. Watson Laforce, Jr., Morris and Flora Mizel, William G. Webb, *et al.*, Robert Beamon, individually and as trustee, Thomas L. Hail, Trustee, and Pattie Ann Beamon Lundell.

[3] Washington Utilities and Transportation Commission, The People of the State of California, The Public Utilities Commission of the State of California, The Public Utility Commissioner of Oregon, City of Ellensburg, Washington, The Public Service Commission of Nevada, The Public Service Commission of Wyoming, Idaho Public Utilities Commission, Pacific Gas and Electric Company, Southern California Gas Company, Southern Union Company, C.P. National Corporation, Colorado Interstate Gas Company, Cascade Natural Gas Corporation, Northwest Natural Gas Company, Rocky Mountain Natural Gas Company, Intermountain Gas Company, Southwest Gas Corporation, Mountain Fuel Supply Company, Washington Natural Gas Company, and Washington Water Power Company.

HISTORY OF THE LITIGATION

During the 1950s, Tenneco Oil, Sun Oil, Continental Oil, Atlantic Richfield, Phillips Petroleum, and several other oil companies entered into gas lease-sale agreements with El Paso Natural Gas Company and Pacific Northwest Pipeline Company, both gas pipeline companies. In return for their working interests in certain leases in the San Juan Basin of New Mexico and Colorado, the oil companies were to receive so-called overriding royalties or production payments. The rates established for these royalties were subject to redetermination at the expiration of the initial term. If at the expiration of the term the parties could not agree on a new rate, the rate was to be fixed by arbitration.

In 1973, Sun Oil and El Paso failed to agree on a new override rate, and the dispute was submitted to arbitration. The arbitration board awarded Sun Oil an override based on the well head price of *intrastate* gas which exceeded the regulated *interstate* rate. Other oil companies then sought redetermination of their rates, and El Paso thereafter brought four actions in the United States District Court for the District of Columbia seeking a declaratory judgment that the royalty recipients were selling gas in interstate commerce within the meaning of section 1(b) of the Natural Gas Act, 15 U.S.C.A. § 717(b). If in interstate commerce, the lease-sale agreements came within the jurisdiction of the Natural Gas Act, and the royalty recipients could not receive more than the interstate rates established by the Federal Power Commission (now the Federal Energy Regulatory Commission).

The suits were consolidated and transferred to the Western District of Texas. 28 U.S.C.A. § 1406. El Paso sought reference of the case to the Commission, and the district court carried the request with the case. At the same time, El Paso filed a complaint with the Commission seeking a determination as to the status of the leases under the Act. After a protracted trial, the district court held the lease-sale agreements were not sales of gas within the meaning of the Act and dismissed the case for want of jurisdiction, implicitly denying El Paso's mo-

tion for reference to the Commission. *El Paso Natural Gas Co.* v. *Sun Oil Co.*, 426 F.Supp. 963 (W.D.Tex.1977). El Paso appealed, moving this Court to refer the matter to the Commission.

The Commission thereafter issued an order instituting a show cause proceeding directed to the jurisdictional issue. *El Paso Natural Gas Co.*, 58 F.P.C. 2181 (1977). Tenneco Oil, Atlantic Richfield, Sun Oil, and others sought review of the order in this Court. We denied their motions to stay the Commission's show cause proceeding but withheld decision of the appeal from the district court pending receipt of the Commission's opinion. *Tenneco Oil Co.* v. *FERC*, 580 F.2d 722 (5th Cir.1978).

A record was fully developed before an administrative law judge. Affirming and adopting the decision of the administrative law judge, the Commission ruled that the lease-sale agreements were within its jurisdiction. *El Paso Natural Gas Co.*, 12 F.E.R.C. ¶ 61,297 (1980). Petitions for review of the Commission's decision were thereafter filed with this Court.

Thus the district court and the Commission, albeit on different records, reached opposite conclusions. Both decisions came before us for review. We heard extended oral argument in October 1981, permitted supplemental briefing to the end of that year and continued to receive helpful memoranda through April 1982.

THE ISSUES

The basic question that confronts the Court on these appeals is whether the natural gas lease-sale agreements are sales of gas within the meaning of the Natural Gas Act, 15 U.S.C.A. § 717-717w. Underlying this ultimate issue are subissues which seem to be no longer critical in light of our decision: (1) since the district court decision preceded the Commission's decision, did it have a *res judicata* effect that bound the Commission? (2) having litigated and lost in the district court, were El Paso and Northwest collaterally estopped from claiming

before the Commission that the transactions are jurisdictional? (3) was the Commission bound to treat the transactions as nonjurisdictional because of its prior rulings in connection with such transfers involving some of the same parties and the same basic facts? and (4) should the district court have referred the jurisdictional issue to the Commission under the doctrine of primary jurisdiction? Other subissues argued but not decided are: (a) whether the Commission prejudged the issues, (b) whether the petitions for review in No. 77-2613 concerning the Commission's decision to conduct a show-cause proceeding on the jurisdictional issue should be dismissed for seeking review of nonfinal interlocutory orders, and (c) whether the Commission's resolution of the jurisdictional question should be given only advisory effect in the court of appeals.

FACTS

The San Juan Basin is located mainly in northwestern New Mexico, with a part extending northward into Colorado. Underlying the Basin are bowl-shaped sandstone formations permeated by large volumes of natural gas. There are three gas productive formations in the Basin: Pictured Cliffs, Mesa Verde, and Dakota. All three are characterized by low to moderate permeability and low porosity. As the district court correctly found, actual drilling is the only method of definitely locating recoverable gas saturations.

Unable to obtain all the gas reserves it desired through conventional wellhead sales, El Paso in 1951 entered into negotiations with Delhi Oil Corporation, a lease holder in the Basin. Delhi and El Paso entered into the first of the lease-sale transactions in issue in this case, GLA (Gas Lease Agreement) 47, in March 1952. In exchange for Delhi's gas reserve acreage, El Paso agreed to pay Delhi a fixed price per Mcf produced, subject to escalation over a specified period of time and thereafter subject to redetermination at the fair market value of the gas. The parties agreed to submit to arbitration any price they could not settle upon.

El Paso's program of acquiring gas reserves in the San Juan Basin, through transactions similar to GLA-47, proceeded rapidly. In all, over a six-year period, El Paso entered into 36 such lease-sale contracts with the owners of gas leaseholds in the Basin, thereby acquiring the gas underlying more than a quarter of a million acres. Thirty-five of these GLAs are in issue here. Prior to the lease-sale transactions, natural gas from some of the acreage had been sold to El Paso under conventional wellhead sales contracts.

All the GLAs followed the same general pattern: in exchange for the producer's agreement to transfer the leasehold, El Paso agreed to make overriding royalty payments for the gas when produced.

In 1952, Pacific Northwest Pipeline Corporation, a prospective interstate natural gas pipeline company, filed an application with the Commission for a certificate of convenience and necessity to build a pipeline to supply gas to the Pacific Northwest market. Since Pacific Northwest had no gas supplies, it sought commitments from independent producers who owned substantial reserves in the San Juan Basin.

Pacific Northwest obtained commitments for San Juan Basin gas from several producers based on a lease-sale format (called "PLAs" for Pacific Lease Agreement) closely similar in most important respects to the GLAs in the El Paso transactions. The basic scheme called for Pacific Northwest to compensate the interest owner of the acreage by paying an overriding royalty, calculated as a specified sum for each Mcf of gas produced from the acreage, subject to periodic escalation. The price was also subject to later redetermination under a specified formula tied to the market, *i.e.*, the unregulated value of the gas. The PLAs conveyed rights only to gas, not oil.

Northwest Pipeline Corporation is the successor in interest, through El Paso, of Pacific Northwest.

JURISDICTIONAL ISSUE

Whether the gas lease-sale agreements are sales of gas within the meaning of the Natural Gas Act, 15 U.S.C.A. § 717-717w, and thus subject to the jurisdiction of the Federal Energy Regulatory Commission, is of substantial significance. If they are sales under the Act, the royalty recipients must seek certification from FERC and cannot receive payments exceeding the regulated interstate rate. If they are not sales, the recipients are entitled to the rate provided in the contracts.

The issue is difficult to decide. Neither the statute nor the cases give definitive direction. Congress intended to regulate only interstate sales of natural gas, leaving intrastate sales and the *production* of gas regulated exclusively by the states, if regulated at all. *See Interstate Natural Gas Co.* v. *FPC*, 331 U.S. 682, 690, 67 S.Ct. 1482, 1487, 91 L.Ed. 1742 (1947). An easy line to draw in legislative halls, in the real world there is much confusion between sales and production, made ever increasingly so by legal craftsmanship that sometimes makes production look like sales, or sales look like production, depending upon the interest of the client.

The main cases addressing the question focus on the geology and development of the acreage and the terms of the contracts involved. The fountainhead decision setting forth the factors to apply in determining whether a transaction is jurisdictional is *United Gas Improvement Co.* v. *Continental Oil Co. ("Rayne Field")*, 381 U.S. 392, 85 S.Ct. 1517, 14 L.Ed.2d 466 (1965). The significant case in this Circuit is *Continental Oil Co.* v. *FPC ("Ship Shoal")*, 370 F.2d 57 (5th Cir. 1966).

While ordinary wellhead sales of natural gas for resale in interstate commerce come within the jurisdiction of the Natural Gas Act, *see Phillips Petroleum Co.* v. *Wisconsin*, 347 U.S. 672, 677, 681-82, 74 S.Ct. 794, 796, 798-99, 98 L.Ed. 1035 (1954), lease transfers and the royalties collected thereunder are generally within "production or gathering" exemption of the Act, 15 U.S.C.A. § 717(b), and thus not jurisdictional. *See Mobil Oil Corp.* v. *FPC*, 463 F.2d 256 (D.C.Cir.1971), *cert.*

denied, 406 U.S. 976, 92 S.Ct. 2409, 32 L.Ed.2d 676 (1972). Difficulties arise, however, where, as in the instant case, the transactions are hybrid, manifesting characteristics of both arrangements.

In the leading case of *United Gas Improvement Co.* v. *Continental Oil Co.*, commonly known as "Rayne Field," the United States Supreme Court directed a case-by-case analysis of hybrid lease-sale arrangements, the fundamental inquiry being whether "the sales of these leases in . . . a proven and substantially developed field . . . accomplished the transfer of large amounts of natural gas to an interstate pipeline company for resale in other states." 381 U.S. at 401, 85 S.Ct. at 1522. The Fifth Circuit expounded on the *Rayne Field* test in *Continental Oil Co.* v. *F.P.C. ("Ship Shoal")*, stating the test as follows:

> (1) Is the economic effect of the transfer similar to that of a conventional sale?
>
> (2) Is the subject of the transaction "proven and substantially developed" reserves?
>
> (3) Is the transfer of the reserves for purpose of interstate transmission and resale?

370 F.2d at 62. *Ship Shoal* further articulated the standard for applying the second factor, whether reserves are "proven and substantially developed" within the meaning of *Rayne Field*, focusing on (1) definability of gas volume based upon proof of reserves and (2) imminent ability to produce in commercial quantities. *Id.* at 63-64.

While both the administrative law judge's decision and that of the Commission invoke *Rayne Field*, it is clear from a careful reading of the administrative law judge's opinion and the Commission's affirmance that neither correctly applied it under the law of this Circuit. In determining whether a transfer is jurisdictional under the Act, *Ship Shoal* teaches that all three of the above factors must be present. The administrative law judge and the Commission, however, elevated the first prong—economic equivalency—from a component in the *Rayne Field*

test to the determinative factor on the issue. Thus, the administrative law judge stated:

> Under the *Rayne Field* case's "economic equivalent" doctrine, a lease-sale agreement would clearly be subject to regulation as a jurisdictional sale of gas at the wellhead if it is held to be economically equivalent in substance to the conventional wellhead sale which the Court held to be jurisdictional in *Phillips*.
>
> * * * * * *
>
> The legal principles fashioned in the *Rayne Field* line of cases, when applied to the facts of this proceeding, lead inescapably to the conclusion that all of the lease-sale agreements at issue are jurisdictional. The crucial test that emerges from the cases is whether a particular transaction accomplished the transfer of large volumes of natural gas reserves to an interstate pipeline for resale in interstate commerce. If it did, the transaction is jurisdictional.
>
> * * * * * *
>
> What is significant is the essential message of *Rayne Field*—that the transfer of large amounts of natural gas reserves to an interstate pipeline for resale in interstate commerce is a jurisdictional transaction, no matter how the lawyers decide to structure the transfer. *Rayne's* specification that "proven and substantially developed reserves" must be present is not a quantitative test, a license for future courts and Commissions to engage in massive well counting in order to ascertain whether some formulaic criterion has been satisfied. Rather, *Rayne* is concerned with commercial realities. It asks whether what was sold was gas or merely the right to explore for and develop it in the uncertain event it is found.
>
> * * * * * *
>
> Here, too, the significant economic fact that will not go away no matter how much the respondents try to wish it away is that the GLA and PLA contracts at issue, each and every one of them, transferred large volumes of natural gas from a producer of natural gas to an interstate natural gas pipeline for transmission and sale for resale in other states. That fact requires the finding that each of the contracts was, as a matter of law, economically equivalent

> to a wellhead sale of natural gas for resale in interstate commerce.

El Paso Natural Gas Co., 6 F.E.R.C. ¶ 63,037, at 65,212; 65,217-19 (1979). In affirming, the Commission held:

> We find the magnitude of the overriding royalties and the fact that they apply to each Mcf of gas sold, irrespective of the quanitities of gas the contracting parties might originally have thought were involved, lends, in our judgment, strong support to the proposition that these lease sales were virtually identical in "economic effect" to conventional sales.

El Paso Natural Gas Co., 12 F.E.R.C. ¶ 61,297, at 61,683 (1980).

By focusing on "commercial realities" and the parties' assumption while negotiating that gas existed in the ground, the administrative law judge and the Commission misread and misapplied *Rayne Field* and *Ship Shoal*, almost ignoring the requirement for a finding of jurisdiction under the Natural Gas Act that the acreage involved must be proven and substantially developed. *See Ship Shoal*, 370 F.2d at 62. Neither the Supreme Court nor our precedents have signaled a retreat from this requirement or indicated it is swallowed up by the first prong of *Ship Shoal's* test. Thus, in holding the lease-sales jurisdictional in *Rayne Field*, the Supreme Court emphasized that the land included "proven and substantially developed" gas reserves. 381 U.S. at 401, 85 S.Ct. at 1522.

Carried to its logical conclusion, the Commission's economic equivalency/commercial realities approach could render any sale of lease rights to an interstate pipeline company jurisdictional merely because the transaction ultimately results in successful production and disposition of gas in interstate commerce. Certainly, El Paso entered into the agreements in question in this litigation with the hope and expectation of obtaining gas for sale in interstate commerce. It had the same goal as a purchaser in the ordinary wellhead sale. But this statement is equally true of the lessee in a traditional transfer of a lease to gas-bearing lands. Unless all the *Rayne Field*

factors, including proven and substantial development, are satisfied, such a transaction is not jurisdictional. *See Mobil Oil Corp.* v. *FPC*, 463 F.2d at 261-62; *see also FPC* v. *Panhandle Eastern Pipeline Co.*, 337 U.S. 498, 69 S.Ct. 1251, 93 L.Ed. 1499 (1949). The Supreme Court emphasized the difference in degree of development in explaining why it held the transaction jurisdictional in *Rayne Field*, but nonjurisdictional in *Panhandle*. *Rayne Field*, 381 U.S. at 403, 85 S.Ct. at 1523. While the Commission's down-playing of the development issue may well foreshadow the next stage in the evolution of the law, for the time being our precedents demand full application of all components of the *Rayne Field* test, including the proven and substantial development factor, as explained in *Ship Shoal*. We perceive the *Rayne Field* test to reflect the Supreme Court's concern with the apparent congressional intent not to regulate production. A purely economic test would seem to encroach on that concern.

Focusing on the "proven and substantially developed" component of *Rayne Field* and *Ship Shoal*, the record reveals the reserves in the Basin may well have been "proven" at least within reasonable estimates. *See generally Ship Shoal*, 370 F.2d at 64-65. The district judge was correct, however, in deciding the lease-sale agreements did not involve substantially developed reserves, and the Commission erred in determining the same transfers did. Specifically, we hold the reserves underlying the leaseholds were not substantially developed at the time the lease sales were executed because of the lack of "imminent ability to produce in commercial quantities." *Ship Shoal*, 370 F.2d at 64.

An important factor in our decision is the limited extent to which the Basin had been drilled at the time the GLAs and PLAs were executed. Although different tracts varied as to development, taking the Basin as a whole, the acreage was far less drilled than the land covered by the agreements found jurisdictional in *Rayne Field*. Unlike in that case, massive efforts were required to make the fields in the Basin commercially productive. For example, GLA No. 47 covered approxi-

mately 102,400 acres. At the time of the signing of the agreement, there were fifteen wells in the Mesa Verde formation and nine in the Pictured Cliffs formation included under the GLA. State law, however, permitted far more extensive drilling: one Mesa Verde well for each 320 acres and one Pictured Cliffs well for each 160 acres. Substantial drilling took place after the agreement was reached. By December 1976, 736 wells were in the ground. An even more dramatic example of the lack of substantial development when the agreements were reached is provided by PLA-5. At the time of the agreement, there were no wells on the 188,000 acres. By December 1977, however, 365 wells were productive. Although a few GLAs and PLAs reflect substantial development, neither the Commission nor the parties have sought to approach the issue here on an individual agreement basis.

In comparison, the acreage in *Rayne Field* featured far more development prior to execution of the agreements. In *Rayne Field*, nineteen wells were in the ground with only seven more to be drilled. 381 U.S. at 396 n.3, 85 S.Ct. at 1520 n.3. This significant drilling enabled the purchaser-lessee to receive gas for interstate distribution shortly after execution. *Id.* at 397, 85 S.Ct. at 1520.

The evidence in the present litigation reveals that the few wells in the ground when the agreements were executed could not have come close to depleting the acreage. For example, even after adding numerous wells in the land covered by GLA-47, the purchaser-lessee sought and received permission to double the number of wells previously allowed under state law in the Mesa Verde formation. According to the purchaser-lessee, the party favoring Commission jurisdiction and arguing the reserves were substantially developed, the additional wells were necessary to deplete the formation.

While the number of wells existing at execution of the agreement is not the *sine qua non* of substantial development, the Commission has considered this factor, and the cases point up its significance. *E.g.*, *Rayne Field*, 381 U.S. at 396 & n.3, 403 &

n.8, 85 S.Ct. at 1520 & n.3, 1523 & n.8; *Texas Gas Transmission Corp.*, Docket No. CP77-612, "Findings and Order After Statutory Hearing Issuing Certificate of Public Convenience and Necessity and Granting Petition to Intervene," at 3 (May 10, 1978). Since substantial development turns on whether the acreage is capable of imminent production of natural gas in commercial quantities, *Ship Shoal*, 370 F.2d at 64, it stands to reason that the actual number of wells in comparison to the number needed to complete production from the land is a relevant factor. As the Supreme Court stated in explaining the relevance of the substantial development criteria, "the more that must be done before the gas begins its interstate journey, the less the transaction resembles the conventional wellhead sale of natural gas in interstate commerce." *Rayne Field*, 381 U.S. at 403, 85 S.Ct. at 1523. The pipeline companies' ability to tie in a few wells shortly after consummation of the transaction does not demonstrate an "imminent ability to produce in *commercial* quantities," *Ship Shoal*, 370 F.2d at 64 (emphasis added), or *substantial* development. We therefore conclude that because the acreage was not substantially developed, the agreements in issue were not sales of gas under the Natural Gas Act.

The pipeline companies urge and the Commission ruled that even if the lease-sales were not covered by the Act at the outset, they "ripened" into jurisdictional transactions when the price paid under the contracts was redetermined through the much later 1973 arbitration. Relying on *Weymouth* v. *Colorado Interstate Gas Co.*, 367 F.2d 84 (5th Cir.1966), the Commission held the price redetermination proceedings constituted a reassertion of "control over the price of gas sold at a time when the gas was undeniably from a proven and substantially developed field." *El Paso Natural Gas Co.*, 12 F.E.R.C. ¶ 61,297, at 61,684 (1980).

We reject the Commission's approach because it is implicit in the controlling authorities that jurisdiction must be evaluated at the time lease-sale agreements are executed. In *Rayne Field*, the Supreme Court found the gas reserves proven and

substantially developed at the time the lease-sales were signed. *See* 381 U.S. at 396, 85 S.Ct. at 1520. Similarly, the Fifth Circuit in *Ship Shoal* treated the pipeline company's readiness to connect to the field upon execution as a "strong indication that the field was 'substantially developed' at the *time of transfer.*" 370 F.2d at 65 (emphasis added).

Weymouth, relied on by the Commission, is inapposite. In that case, the parties entered into a new lease which superseded various individual leases and incorporated many substantial changes. The Fifth Circuit referred the case to the Commission for a jurisdictional determination, noting the applicability of the Natural Gas Act to agreements reached or significantly altered after the date of its enactment. 367 F.2d at 102. In the instant case, however, redetermination of rates followed precisely according to the terms of the lease-sale agreements which remained unchanged. The mere redetermination of rates pursuant to the original contracts does not render the arrangements sales and is not factually analogous to the exercise of a retained right to withhold consent to sublease or assign, deemed jurisdictional in *Louisiana Land and Exploration Co.* v. *FERC*, 574 F.2d 204 (5th Cir.), *cert. denied*, 439 U.S. 1127, 99 S.Ct. 1043, 59 L.Ed.2d 88 (1979). Thus, in the absence of authority commanding a contrary rule, we hold the agreements must be evaluated for jurisdiction under the Natural Gas Act as of the date of execution.

PRIMARY JURISDICTION, RES JUDICATA, COLLATERAL ESTOPPEL

The issue concerning FERC's statutory jurisdiction was pending simultaneously before both the agency and the district court. Throughout this litigation both the purchaser-lessees and the Commission have consistently maintained that under the doctrine of primary jurisdiction, the agency's expert and specialized knowledge should have been utilized from the outset and that the district court erred in failing to refer the case to the Commission for initial determination.

Whether the district court should have referred this action to the Commission under the doctrine of primary jurisdiction is, at this juncture, without consequence. Our decision in this case has been preceded by and we have considered *both* tribunals' decisions so that the spirit of the flexible doctrine, if not the letter, has been satisfied. *Cf. J.M. Huber Corp.* v. *Denman*, 367 F.2d 104, 111 (5th Cir.1966) (primary jurisdiction is a flexible doctrine). Beyond holding that we did not, as has been argued, refer the jurisdiction issue to the Commission in *Tenneco Oil Co.* v. *FERC*, 580 F.2d 722 (5th Cir.1978), this question requires no further analysis.

Similarly, we need not decide the res judicata or collateral estoppel effect, if any, of the district court opinion vis-a-vis the decision of the Commission. Our holding that the district court decision is not clearly erroneous as to the lease-sale agreements before it and that the Commission's ruling is not supported by substantial evidence obviates the need for a detailed discussion of these issues. Those parties claiming the Commission's actions were precluded by the doctrine, especially William G. Webb, et al., prevail under our approach even without their rationale. *See William G. Webb*, 49 F.P.C. 17(1973).

NO. 77-1762: AFFIRMED.

NO. 77-2613: DISMISSED.

NO. 80-2404: REVERSED.

2. ORDER OF FEDERAL ENERGY REGULATORY COMMISSION AFFIRMING INITIAL DECISION AND INITIATING FURTHER HEARING, *EL PASO NATURAL GAS CO.*, 12 FERC ¶ 61,297 (SEPTEMBER 25, 1980)

12 FERC ¶ 61,297

El Paso Natural Gas Company, Docket No. CP74-314; Northwest Pipeline Corporation, Docket No. CP76-327; Sun Oil Company, et al., Docket No. CI77-526

Order Affirming Initial Decision and Initiating Further Hearing

(Issued September 25, 1980)

[Initial decision issued February 20, 1979 appears at 6 FERC ¶ 63,037.]

Syllabus

Commission *affirms* without modification that a series of lease-sale agreements constituted sales of natural gas for resale in interstate commerce under the Natural Gas Act.

[1] PIPELINE-RATEMAKING & REGULATION

Jurisdiction

Commission *finds* that overriding royalty owners initially received approximately the same net amount under lease-sale contracts as would have been received under conventional wellhead sales after costs of production were considered. The magnitude of the overriding royalties and the fact that they apply to each Mcf of gas sold, irrespective of the quantities of gas the contracting parties might originally have thought were involved, strongly supports this finding and leads the Commission to *conclude* that the lease-sales are jurisdictional.

[2] PIPELINE-RATEMAKING & REGULATION

Jurisdiction

Commission *finds* that persons acquiring leases of land later sold to pipelines were not real estate speculators. Instead these lease-sales accomplished the transfer of natural gas to an interstate pipeline company for resale in other states. The sellers bought leases from the original landowners and sold the gas contained in those leases to the pipelines. The original

landowners received a standard royalty for the rights which they sold and controlled no aspects of the ultimate sale of the gas to pipelines. The Commission also *finds* the inclusion of take-or-pay provisions and the section of noncommercial acreage provision in the lease-sale contract between pipelines and those acquiring the leases leads to the conclusion that gas, not land, was being sold.

[3] PIPELINE-RATEMAKING & REGULATION

Jurisdiction

Commission *reaffirms Weymouth* decision in finding that the lease-sales in question are subject to Commission jurisdiction. Assuming *arguendo* that the lease-sales were not initially jurisdictional, they became so at the time the price paid for the gas pursuant to the contracts was redetermined through arbitration and thereby established at levels equal to or approaching prevailing wellhead prices. Upon redetermination of price, the sellers reasserted their control over the price of gas sold at a time when the gas was undeniably from a proven and substantially developed field.

[4] PIPELINE-RATEMAKING & REGULATION

Jurisdiction

Commission *rejects* argument that Commission is barred by the doctrines of *res judicata* and collateral estoppel from holding lease-sale transactions to be jurisdictional. *Webb-Turner* did not directly decide that lease-sales were non-jurisdictional. That ruling was based on less than a complete record and reached under different circumstances. In light of the increasing burden on consumers of non-regulation of these lease-sale transactions, the FPC was compelled to throughly examine these lease-sales to determine whether they were jurisdictional. After redetermination of prices, changes in fundamental facts further necessitated a review of the jurisdictional issue. The Commission has also been ordered by the Fifth Circuit to decide whether the subject lease-sale contracts are sales of

natural gas for resale in interstate commerce as defined by the Natural Gas Act.

[5] PIPELINE-RATEMAKING & REGULATION

Refunds & Restitution

Commission *remands* for determination of the remedial measures to be taken, including: (1) whether and if so to what extent payments made by pipelines to overriding royalty owners were excessive and therefore unlawful; (2) what amounts, if any, should be required to be refunded by royalty owners to pipelines and flowed through by them to their jurisdictional customers; and (3) what level of royalties should be approved for the future.

Paul R. Connolly, J. Alan Galbraith and *Arthur R. Formanek* for El Paso Natural Gas Company

David K. Watkiss, Jack W. Hanks and *Joseph T. Casey* for Northwest Pipeline Corporation

Gordon Gooch and *Charles M. Darling, IV* for Tenneco Oil Company, Continental Oil Company, American Petrofina Company of Texas, Crown Central Petroleum Corporation, Delta Drilling Company and Mr. & Mrs. Morris Mizel

Michael J. Henke and *MaryJane Reynolds* for Union Oil Company of California

Craig W. Hulvey for Mobil Oil Corporation and Getty Oil Company

George Mickum, Steven H. Brose and *Edward Leahy* for Atlantic Richfield Company

Leo J. Hoffman for Sun Oil Company (Delaware)

John L. Williford and *Larry Pain* for Phillips Petroleum Company

R. H. Landt for Amoco Production Company

Terry R. Barrett and *Stanley L. Cunningham* for F.H.N., Ltd.

William B. Browder, Jr. for W. Watson LaForce, Jr., *et al.*

J. O. Terrell Couch for Robert Beamon, *et al.*

Sherman S. Poland and *Bernard A. Foster, III* for William G. Webb, *et al.*

John S. Fick and *Thomas D. Clarke* for Southern California Gas Company

Shirley A. Woo, Malcom Furbush and *Peter Hanson* for Pacific Gas and Electric Company

Edwyn R. Sherwood, Henry E. Brown and *Joel L. Greene* for Colorado Interstate Gas Company

Bruce R. Debolt and *John H. Socolofsky* for the Oregon Public Utility Commissioner

Radovan Z. Pinto for the People of the State of California and the California Public Utilities Commission

Richard E. Kelly for the Staff of the Federal Energy Regulatory Commission

Before Commissioners: Charles B. Curtis, Chairman; Georgiana Sheldon, Matthew Holden, Jr. and George R. Hall.

[Order Text]

On February 20, 1979, the presiding administrative law judge issued an initial decision in the above-captioned proceeding. The judge found that a series of lease-sale agreements, which are the subject matter of this proceeding, constituted sales of natural gas for resale in interstate commerce under the Natural Gas Act. We agree with the judge's determination and find nothing in the exceptions thereto warranting modification of his decision.

[1] We do, however, want to stress several factors leading to the conclusion that the lease-sales at issue are in fact jurisdictional. The law judge found that the overriding royalty owners initially received approximately the same net amount under the lease-sale contracts as they would have received under conventional wellhead sales after costs of production were considered. The presiding judge also noted that when the overriding royalty payments were redetermined as provided

for in the lease-sale contracts, they were established at the fair-market value of wellhead sales in the case of the contracts of El Paso Natural Gas Company, and at 75% of wellhead value in the case of the contracts now held by Northwest Pipeline Company. The overriding royalties were to be paid on each Mcf of gas produced. These payments are sharply different from payments normally made in a royalty situation. In an ordinary royalty contract, the royalty owner is paid a royalty based on a percentage of the value of production. Here, however, the royalty owners are receiving royalties based on the fair-market value at wellhead for each Mcf produced. These payments are virtually equivalent to the payments that would have been received in a conventional wellhead sale except that in an ordinary wellhead sale the producers would be expected to absorb the costs of production. In this case, of course, the royalty owners are responsible for none of the production costs. The pipelines are instead responsible for production costs and such costs are passed on to their customers (and to the ultimate consumer) in addition to the overriding royalties paid to the lessors. We find that the magnitude of the overriding royalties and the fact that they apply to each Mcf of gas sold, irrespective of the quantities of gas the contracting parties might originally have thought were involved, lends, in our judgment, strong support to the proposition that these lease sales were virtually identical in "economic effect"[1] to conventional sales.

[2] The law judge also found that persons who acquired the leases and sold them to the pipelines were not real estate speculators. The sellers bought leases from the landowners and then sold the gas contained in those leases to the pipelines. The landowners, who were the original sellers of the leases, received a standard royalty for the rights which they sold. They negotiated that royalty with the persons who sold the

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[1] *United Gas Improvement Co.* v. *Continental Oil Co.* ("Rayne Field"), 381 U.S. 392, 396 (1965).

leases to the pipelines. The original landowners had no control over the ultimate destination of any gas which might be discovered, and no knowledge whether the gas, if discovered, will be sold interstate or intrastate. Nor did the landowners control the quantity to be sold, the price to be paid, or the identity of the purchaser. The middlemen sellers controlled all these incidents of sale. They sold the gas to the interstate pipelines, specified how much was to be sold per year, negotiated the price, and dealt with the purchasing pipelines. The sellers of these lease-sale agreements were not landowners selling rights to drill. They were sellers of the natural gas contained in acreage which they had leased from landowners.

[2] We also wish to stress certain contractual provisions which lead us to the conclusion that it was gas, proved reserves, which was being sold. The take-or-pay provisions, and the return of non-commercial acreage provisions, are significant in our determination that what was being sold was gas.

[2] The take-or-pay provisions are commonly found in conventional sales contracts and support our conclusion that these transactions contemplated the sale of proved reserves. Moreover, the return of non-commercial acreage provisions show that all that was being sold was proved reserves as measured by the results of actual drilling. The only difference between these lease sales and producer sales, which may include clauses giving the buyer an option not to attach reserves from wells deemed non-commercial,[2] is the fact that the buyers incurred the risks and costs associated with drilling. Yet this difference is one which, in our view, supports, and certainly does not detract, from our conclusion that these agreements are the functional equivalent of sales from successful wells by producers. We conclude that the evidence amply demonstrates that

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[2] *See Mitchell Energy Corporation*, Docket No. CI78-704, Order Denying Petition For Declaratory Order, Directing Applicant to File For Abandonment Authorization and Granting Intervention (October 23, 1979, 9 FERC ¶ ____).

these lease sales "accomplished the transfer of large amounts of natural gas to an interstate pipeline company for resale in other States."[3]

[3] In support of the proposition that the lease-sales in question are subject to the Commission's jurisdiction, the staff cites several cases including *United States* v. *Southwestern Cable Co.*, 392 U.S. 157 (1968), *Mobil Oil Corp.* v. *F.P.C.*, 463 F.2d 256 (D.C. Cir. 1971) and *Fanny Fern Weymouth* v. *Colorado Interstate Gen. Co.*, 367 F.2d 84 (5th Cir. 1966). We are not persuaded that either the *Southwestern Cable* or *Mobil* case is directly relevant to the jurisdictional issue presented in this case. However, we do believe that support for the assertion of Commission jurisdiction is provided by *Weymouth*. In that case the court stated:

> Unlike *Huber* which involves a lease from the Landowner to the Lessee-Producer who in turn sells the gas to Northern, the Pipeline Purchaser, this transaction from its inception was a one-step affair. It is between the Landowner-Lessor and the Pipeline as Lessee and Purchaser. Considering that the Natural Gas Act applies from the date of its enactment, at least to all transactions which come into being or are significantly altered thereafter—whether the parties are aware of the existence of the legislation or whether it is being actively enforced—there is at least a possibility that, taking into account the nature and extent of the reserves of this huge gas field, at some stage or time and to some extent, this transaction ripened into a "sale" of a kind comparable to that found to exist in Rayne Field. (367 F.2d at 102).

[3] Assuming *arguendo* that the lease-sales here were not initially jurisdictional, we think that they became jurisdictional at the time the price paid for gas pursuant to these contracts was redetermined through arbitration and thereby established at levels equal to or approaching prevailing wellhead prices.

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[3] 381 U.S. at 401.

Upon the redetermination of price, the sellers reasserted[4] their control over the price of gas sold at a time when the gas was undeniably from a proven and substantially developed field.

[4] In their exceptions to the initial decision, the royalty owners argue that this Commission is barred by the doctrines of *res judicata* and collateral estoppel from holding these transactions to be jurisdictional.[5] The FPC previously rejected those contentions and we continue to do so. We cannot be bound by the conclusion drawn by the FPC in the *Webb-Turner*[6] proceeding. This Commission has a continuing obligation to regulate sales which Congress has declared to be within

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[4] The sellers in negotiating the initial contracts had control over all incidents of sale which a conventional seller-producer, as opposed to a landowner-royalty owner, would have. These included the ability to contract of the quantity to be sold, the price to be paid, the identity of the purchaser and whether it shall be sold in interstate or foreign commerce. In initially contracting for a price for gas, the sellers reserved the right to redetermine the price after the initial contract period. They exercised this right which resulted in an arbitrated finding of prices for the gas in excess of applicable FPC ceiling prices. In stating that the arbitrators found that the contracts provided for prices higher than the FPC ceiling prices, we in no way imply that that result is consistent with applicable law or with the intent of the parties at the time the agreements were negotiated.

[5] Respondents also claim that this case is similar to *Texas Gas Transmission Corporation*, Docket No. CP77-612, Findings and Order After Statutory Hearing Issuing Certificate of Public Convenience and Necessity and Granting Petition to Intervene (May 10, 1978, 3 FERC ¶ ____), in which we found that a sale of gas reserves in place did not constitute a jurisdictional sale. *Texas Gas* is inapposite. The sale in *Texas Gas* involved reserves where the magnitude of reserves was unknown. And more importantly, the purchase price was not tied to the level of any future production or to the magnitude of reserves ultimately discovered. In this case, the purchase price was tied directly to the level of future production.

[6] *Webb-Turner*, Opinion No. 642, 49 FPC 17 (1973).

the Commission's jurisdiction. The Commission cannot waive that jurisdiction.[7] The producers, in this case, have no right to continued non-regulation.[8] And the producers can show no harm from relying on the FPC's decision in the *Webb-Turner* proceeding.

[4] Moreover, the *Webb-Turner* proceeding arose in a different context. It involved primarily issues of wheher to grant the *Webb-Turner* parties permission to abandon sales to El Paso, whether to grant El Paso a certificate to operate the facilities involved in those sales, and what costs related to the gas in question were properly includable in El Paso's cost-of-service. In *Webb-Turner*, the FPC did not directly decide that the lease-sale transactions were non-jurisdictional. Rather it found that it would not impose a *Rayne*-type remedy in that case. Although in so doing the FPC, in essence, indicated that it considered the lease-sales not to be jurisdictional, in view of more recent events there can be no dispute that the FPC's rather oblique ruling was based on less than a complete record and was reached under substantially different circumstances. In light of the increasing burden of consumers of non-regulation of these lease-sale transactions, the FPC was compelled to thoroughly examine these lease-sales to determine whether they are in fact jurisdictional. Prior to the price redetermination, payments were of less regulatory interest to the Commission. After redetermination, when regulatory interest in these leases was greater, changes in fundamental facts necessitated a thorough review of the jurisdictional issue. Additionally, this Commission has been directed by the Fifth Circuit to decide whether the subject lease-sale contracts are sales of natural gas for resale in interstate commerce as defined

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[7] *Brooklyn Union Gas Co.* v. *F.E.R.C.*, 627 F.2d 462 (D.C. Cir. 1980), at 7.

[8] *Nantahala Power and Light Co.* v. *F.P.C.*, 384 F.2d 200 (4th Cir. 1967); *Connecticut Light and Power Co.* v. *F.P.C.*, 557 F.2d 349 (2nd Cir. 1977).

by the Natural Gas Act.[9] For these reasons, the *res judicata* and collateral estoppel arguments cannot stand.

The royalty owners have requested oral argument. They point to the magnitude of the briefs, the lengthy record, and the factual and legal complexity of the issues as reason for oral argument. The case has been well briefed and we feel that oral argument is unnecessary for a thorough review and resolution of the case. Therefore, oral argument will be denied.

[5] Having found that the subject lease-sale agreements are sales of natural gas as defined by the Natural Gas Act, the remains to be decided what remedies should be adopted for past and future periods. Numerous questions remain as to what remedies are available and what action or combination of actions should be taken to insure that consumers are afforded the "complete, permanent and effective bond of protection from excessive rates and charges"[10] contemplated by the Natural Gas Act. These issues were previously discussed by the FPC in its order issued in these dockets on June 3, 1977 58 FPC. However, the FPC later phased the proceeding and deferred the remedy issues until the jurisdictional issue had been decided. This case shall be remanded for hearing and decision of the remaining issues including those set forth in the order of June 3, 1977. The basic issues to be addressed on remand are (1) whether and if so to what extent were the payments made by El Paso, Northwest and PNW to the overriding royalty owners excessive and therefore unlawful, (2) what if any amounts should be required to be refunded by the royalty owners to El Paso and Northwest and flowed through by them to their jurisdictional customers, and (3) what level of royalties should be approved for the future?

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[9] *Tenneco Oil Co.* v. *F.E.R.C.*, 580 F.2d 722, 724 (5th Cir. 1978).

[10] *Atlantic Refining Co.* v. *P.S.C. of New York* ("CATCO") 360 U.S. 378, 388 (1959).

THE COMMISSION ORDERS:

(A) The initial decision of the administrative law judge is affirmed and adopted.

(B) The motion for oral argument is denied.

(C) A hearing shall be held to determine proper remedies for past and future periods in accordance with the terms of this order.

(D) A presiding administrative law judge to be designated by the chief administrative law judge shall preside at the hearing in this proceeding, with authority to establish and change all procedural dates, and to rule on all motions as provided in the rules of practice and procedure.

3. ALJ'S INITIAL DECISION ON JURISDICTIONAL STATUS OF LEASE SALE AGREEMENTS, *EL PASO NATURAL GAS CO.*, 6 FERC ¶ 63,037 (February 20, 1979)

6 FERC ¶ 63,037

El Paso Natural Gas Company, Docket No. CP74-314; Northwest Pipeline Corporation, Docket No. CP76-327; Sun Oil Company, et al., Docket No. CI77-526

Presiding Administrative Law Judge's Initial Decision on Jurisdictional Status of Lease-Sale Agreements

(Issued February 20, 1979)

[Note: Order affirming Initial Decision and initiating further hearing was issued September 25, 1980, and appears at 12 FERC ¶ 61,297.]

Appearances

Paul R. Connolly, J. Alan Galbraith and *Arthur R. Formanek* for El Paso Natural Gas Company

David K. Watkiss, Jack W. Hanks and *Joseph T. Casey* for Northwest Pipeline Corporation

Gordon Gooch and *Charles M. Darling, IV* for Tenneco Oil Company, Continental Oil Company, American Petrofina Company of Texas, Crown Central Petroleum Corporation, Delta Drilling Company, and Mr. & Mrs. Morris Mizel

Michael J. Henke and *Mary Jane Reynolds* for Union Oil Company of California

Craig W. Hulvey for Mobil Oil Corporation and Getty Oil Company

George Mickum, Steven H. Brose and *Edward Leahy* for Atlantic Richfield Company

Leo J. Hoffman for Sun Oil Company (Delaware)

John L. Williford and *Larry Pain* for Phillips Petroleum Company

R.H. Landt for Amoco Production Company

Terry R. Barrett and *Stanley L. Cunningham* for F.H.N., Ltd.

William B. Browder, Jr. for W. Watson LaForce, Jr., *et al.*

J. O. Terrell Couch for Robert Beamon, *et al.*

Sherman S. Poland and *Bernard A. Foster, III* for William G. Webb, *et al.*

John S. Fick and *Thomas D. Clarke* for Southern California Gas Company

Shirley A. Woo, Malcolm Furbush, and *Peter Hanson* for Pacific Gas and Electric Company

Edwyn R. Sherwood, Henry E. Brown, and *Joel L. Greene* for Colorado Interstate Gas Company

Bruce R. Debolt and *John H. Socolofsky* for the Oregon Public Utility Commissioner

Radovan Z. Pinto for the People of the State of California and the California Public Utilities Commission

Richard E. Kelly for the Staff of the Federal Power Commission and the Staff of the Federal Energy Regulatory Commission.

BENKIN, *Presiding Administrative Law Judge:*

I

These three cases have been consolidated for investigation under Section 5 of the Natural Gas Act.

The focus of the inquiry is a series of "lease-sale agreements" contracts which transferred ownership of the natural gas reserves underlying a vast amount of acreage in the San Juan Basin.

Most of the San Juan Basin lies in northwestern New Mexico, but a part of it extends northward into Colorado. It is high, semiarid country. The land appears to be unpromising; one

witness described it as "a lot of scenery [and] goat pasture."[1] There was a time when so little was thought of the prospects for the San Juan Basin that most of the land was given to the Indians. Today, we know better: the bowl-shaped sandstone formations that underlie the Basin are permeated by enormous volumes of natural gas. Nearby in the "Four Corners" area are some of the Nation's most abundant deposits of coal.[2] So the Basin, despite its unprepossessing appearance and its isolation from major population centers, is rich.

More than two decades ago, the independent producers who owned the working interests in oil and gas leases covering large tracts of land in the San Juan Basin entered into a series of contracts by which they transferred their leasehold rights to the gas reserves underlying the acreage. The transferees were two corporations. One was El Paso Natural Gas Company (El Paso), a jurisdictional interstate natural gas pipeline. The other, Pacific Northwest Pipeline Corporation (PNW), was soon to become a jurisdictional natural gas pipeline. Under the so-called lease-sale agreements, the interest owners reserved the right to receive certain payments — termed "overriding royalties" — determined by multiplying a specified unit sum by the volume of gas (in Mcf) that the pipelines extracted from the acreage.[3] In time, each royalty would escalate until it would be set at a figure approximating the fair market value of the gas produced.

The question for decision in this proceeding, aspects of which have previously been litigated before a Federal District Court, is whether the lease-sale agreements constituted sales of natural gas for resale in interstate commerce. If, as a matter of law,

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[1] Tr. 337.

[2] See *Chemehuevi Tribe of Indians* v. *F.P.C.*, 420 U.S. 395, 397 n.3 (1975).

[3] In some of the agreements, the overriding royalty payments defrayed the pipeline's obligation to make a "production payment" for gas extracted.

they were, it follows that the agreements have been subject to the regulatory jurisdiction of the Commission under the Natural Gas Act.[4] The principal consequence of a determination that the lease-sale agreements were jurisdictional sales of natural gas would be a holding that the provisions of the agreements which purported to obligate the pipeline-buyers to pay the producer-interest owners amounts (whether or not denominated royalties) exceeding the FPC/FERC-established ceiling prices for gas of the vintages involved were, to that extent, illegal. From such a holding it might also follow that a large portion of the huge sums paid for gas produced under the agreements may have to be refunded and may eventually find its way back into the pockets of ratepayers in California and the Pacific Northwest from whom the funds were exacted in the first place.[5]

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[4] See § 1(b) of the Act, 15 U.S.C. 717(b). At the time this proceeding was begun, the "Commission" in question was the Federal Power Commission. The Federal Power Commission was abolished and was replaced by the Federal Energy Regulatory Commission, which assumed most of the FPC's jurisdiction, under the Department of Energy Organization Act, 42 U.S.C. 7101-7352. The DOE Organization Act took effect on October 1, 1977. This proceeding is continued before the new Federal Energy Regulatory Commission pursuant to §§ 402(a) and 705(b) of the DOE Organization Act, 42 U.S.C. 7172(a), and 7295(b).

[5] The parties have not had the opportunity to submit briefs or arguments on the effect of a holding that the agreements are jurisdictional upon the pricing of the gas under the Natural Gas Policy Act of 1978. Hence, that question will not be dealt with in this decision. Another question that will not be considered in this decision is the matter of criminal liability under Section 21 of the Natural Gas Act, 15 U.S.C. 717t, in the event the Commission determines that the lease-sale agreements constituted unlawful (because uncertificated) jurisdictional sales at above-ceiling prices. Early in the proceeding, Commission Staff Counsel expressly disclaimed any intention on the Staff's part to consider this case for reference to the Department of Justice. Tr. 69.

In order to dispose of the issues, the Commission must necessarily undertake a substantial exercise in historical detective work. In addition, despite the existence of several definitive judicial pronouncements on the subject, from the Supreme Court and elsewhere, the Commission must apply some still-nascent legal principles.

II

This investigation proceeding was instituted by an order of the Federal Power Commission issued on June 3, 1977, 58 FPC 2181, exactly three years after El Paso had filed a complaint asking the Commission to undertake the investigation.[6] Part of the three-year delay was occasioned by the Commission's decision, announced on April 8, 1976, 55 FPC 1677, to defer action upon the complaint pending disposition of litigation then going forward in the United States District Court in Midland, Texas, involving issues identical to those raised by El Paso's complaint to the Commission.[7] The District Court suit came to an end on January 27, 1977.[8]

According to the Commission, the primary question to be determined in this investigation proceeding is whether the "lease-sale" agreements between the pipelines and various owners of working interests in acreage in the San Juan Basin constitute jurisdictional sales of natural gas for resale within

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[6] *El Paso Natural Gas Co.*, Docket No. CP74-314, *et al.*, Order Instituting Show Cause Proceeding, Ordering Filing of Evidence and Ordering Hearing, issued June 3, 1977 (hereinafter cited as Order Instituting Proceeding).

[7] See *El Paso Natural Gas Co.*, Docket No. CP74-314, *et al*, Order Deferring Action on Request to Show Cause, Denying Motions and Permitting Intervention, issued April 8, 1976. There is, so far as the record shows, no explanation for the almost two-year delay between the filing of the complaint and issuance of the April 8, 1976 order.

[8] See n. 19, *infra*.

the meaning of Section 1(b) of the Natural Gas Act as it was construed in *Rayne Field*[9] and the progeny of that case.

After El Paso filed its complaint, Northwest Pipeline Corporation (Northwest) filed a petition for leave to intervene in the proceeding. Northwest, like El Paso a jurisdictional interstate natural gas pipeline, is the successor in interest to the lease-sale agreements that were executed by PNW in the 1950's and that eventually came into Northwest's hands by virtue of a court-ordered divestiture.[10] In its April 8, 1976 order, the Commission directed that Northwest's intervention petition would be treated as a § 5 complaint and would be given its own docket number. Thereafter, in the June 3, 1977 order instituting this proceeding, the Commission joined as respondents in the proceeding the interest owners who were parties to the El Paso lease-sale agreements (sometimes called GLAs) and the interest owners who were parties to the lease-sale agreements (denominated PLAs) that had made their way into the hands of Northwest.[11]

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[9] *United Gas Improvement Co.* v. *Continental Oil Co.*, 381 U.S. 392 (1965).

[10] In 1957, after PNW entered into various lease-sale agreements, El Paso acquired all of the outstanding stock of PNW. Two years later, PNW was merged into El Paso, and all of PNW's assets, including its interests under the lease-sale agreements, became part of the Northwest Division of El Paso. After a decade of antitrust litigation, necessitating five separate opinions by the Supreme Court of the United States, El Paso was forced to divest itself of the PNW assets. (*California-Pacific Utilities Co.* v. *United States*, 410 U.S. 962 (1973), *aff'g United States* v. *El Paso Natural Gas Co.*, 358 F. Supp. 820 (D. Col. 1972); *Utah Public Service Comm'n.* v. *El Paso Natural Gas Co.*, 395 U.S. 464 (1969); *Cascade Natural Gas Corp.* v. *El Paso Natural Gas Co.*, 386 U.S. 129 (1967); *United States* v. *El Paso Natural Gas Co.*, 376 U.S. 651 (1964); *California* v. *F.P.C.*, 369 U.S. 482 (1962).

[11] "GLA" means "Gas Lease Agreement" and is the designation given by El Paso to the lease-sale agreements made with El Paso. El Paso designated each of the lease-sale agreements it acquired fron

The Commission also noted that some four years earlier it had issued an opinion which dealt with the question whether certain of the lease-sale agreements were jurisdictional sales of natural gas. In that case, *William G. Webb, et al.* (Opinion No. 642),[12] the Commission had authorized certain of the interest owners—known as the Webb-Turner parties—to abandon conventional sales to the interstate market in order to consummate their contracts to make lease-sales of their acreage to El Paso. Both the Commission Staff and the State of California had argued that the lease-sales themselves were jurisdictional under the *Rayne Field* doctrine. The Commission had distinguished *Rayne Field* and rejected that argument.[13] The June 3, 1977 order initiating the instant proceeding expressly made the interest owners who were parties to the *Webb, et al.*, Opinion No. 642 case parties to this case. The Commission said that it wanted to review the holding in Opinion No. 642 in light of today's changed circumstances, holding that the doctrine of *res judicata* did not preclude relitigation of the jurisdictional issue decided in that Opinion.[14]

PNW as a "PLA," which stands for "Pacific Lease Agreement." The PLAs are now owned by Northwest, of course, and Northwest has continued to use the El Paso terminology to designate the contracts.

[12] 49 FPC 17 (1973).

[13] *Id.* at 25-26.

[14] In its Order Instituting Proceeding, the Commission said that the *Webb* decision "did not consider at that time whether the continuing production payment itself was a sale." 59 FPC 1209 at 1214-1215. As the Commission acknowledged in its July 29, 1977 order on rehearing, however, that statement was incorrect. Nevertheless, the Commission on rehearing adhered to its determination to reconsider the jurisdictional holding in *Webb* in light of "the changed circumstances of today" and to its conclusion that "The doctrine of res judicata does not apply where changed circumstances appear." *El Paso Natural Gas Co.*, Docket No. CP74-314, *et al.*, Order on Rehearing, Ruling on Motions for Deferral of Proceedings, Granting Motion to Designate Additional Parties, Granting Late Interventions and Granting Motion to Delete Respondent, issued July 29, 1977, 59 FPC 1214-1215 (hereinafter cited as Order on Rehearing).

The event which precipitated the entire controversy was a dispute between El Paso and Sun Oil Company, the owner of the "overriding royalty" interest under GLA 61. That agreement provided for redetermination of the rate of the per-Mcf overriding royalty payable to the interest owner at specified intervals; after 15 years, the royalty was to be a rate fixed by mutual agreement of the parties (but not less than ten cents per Mcf). In the absence of agreement between the parties, the contract provided for determination of the royalty rate by a board of arbitrators who "shall base their decision on the then value of such gas at the well head."[15] In 1973, after the 20-year price-redetermination point arrived, El Paso and Sun were unable to agree on a mutually-acceptable royalty rate. At Sun's insistence, the dispute was submitted to a board of arbitrators. The board agreed with Sun's contention that, under GLA 61, it was entitled to the full market value of the gas at the wellhead, and that the operative standard for establishing market value was the going wellhead price for natural gas in the intrastate market. The board's decision, issued in 1973, rejected the contention that the market value of the GLA 61 gas should be equal to the lower FPC-established rate for interstate sales of gas of the same vintage. The board set the royalty rate for El Paso's payments to Sun at 40 cents per Mcf.[16]

Upon learning of the Sun award, other GLA and PLA interest owners demanded redetermination of the rates applicable to their per-Mcf overriding royalties, under either rate redetermination or favored nations clauses in their lease-sale

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[15] Exh. 22, p. 9.

[16] The respondents assert that the arbitrators' award of 40 cents per Mcf was substantially less than the prevailing intrastate price in the vicinity; 55-60 cents per Mcf. See Respondents' Initial Brief, p. 25. It is nonetheless conceded that the FPC-regulated interstate price for flowing gas of similar vintage was 24 cents per Mcf. See Complainants' Proposed Findings of Fact (hereinafter "CPFF") No. 193, p. 61; Responses of Designated Respondents to Complainants Proposed Findings of Fact (hereinafter "RCPFF"), No. 193, p. 101.

agreements.[17] El Paso's response to these demands was to file four separate lawsuits in U.S. District Court against some interest owners under the GLAs. The actions, which were eventually consolidated and transferred for trial to the District Court for the Western District of Texas, sought declaratory judgments that the lease-sale transactions were in reality jurisdictional natural gas sales which had to be the subjects of FPC-issued certificates of public convenience and necessity before any overriding royalties could lawfully be collected. In addition, El Paso sought to enjoin any interest owner from following Sun's lead and seeking an arbitration award. On June 3, 1974, having filed its complaint with the Commission, El Paso moved in the District Court for a stay of proceedings and for reference of the suit to the Commission. The Court withheld decision on the motion (and, in fact, simply never ruled on it). The District Court did, however, issue an order on August 1, 1974, permitting Northwest to intervene in the litigation. It did so because after the suits were instituted, Northwest succeeded to El Paso's interest in one of the lease-sale agreements on which El Paso had sued.[18]

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[17] The typical favored nations clause provided that the interest owner would receive the highest overriding royalty rate paid by the pipeline-producer for gas produced under any lease-sale agreement covering acreage located within 200 miles of the interest owner's acreage.

[18] See n. 10, *supra*. The lease-sale agreement was PLA 13 with Mobil Oil Corporation as the interest owner. Northwest acquired El Paso's rights under PLA 13 on February 1, 1974. After having made the acquisition, Northwest not only intervened in El Paso's suit in order to assert its interests under PLA 13, but also sought to join as parties to the suit the interest owners who were parties to the remaining PLAs which were not involved in El Paso's action, so that it could obtain an adjudication of its rights and liabilities under the PLAs. The District Court, however, refused to permit joinder of the remaining independent producers.

On January 27, 1977, after a 26-day trial and four days of oral argument, the District Court issued its decision.[19] The Court held that the lease-sale transactions were not sales of natural gas for resale within the meaning of Section 1(b) of the Natural Gas Act and, consequently, were not subject to the regulatory jurisdiction of the Commission.[20] The District Court thereupon dismissed the suits for lack of subject-matter jurisdiction.[21] The judgment of the District Court was appealed to the United States Court of Appeals for the Fifth Circuit.[22] The Fifth Circuit was also the venue of petitions filed by a number of respondents, seeking immediate judicial review of the Commission's order of June 3, 1977 sending this case to hearing and its July 29, 1977 order denying rehearing of the June 3 order.[23] The Court of Appeals consolidated the various cases for argument and, on September 6, 1978, issued an order deferring its ruling on all of the appeals pending the Commission's decision in this proceeding.[24]

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[19] *El Paso Natural Gas Co.* v. *Sun Oil Co.*, 426 F. Supp. 963 (W.D. Tex. 1977).

[20] *Id.* at 970.

[21] *Id.* at 971.

[22] *El Paso Natural Gas Co.* v. *Sun Oil Co.*, No. 77-1762.

[23] *Tenneco Oil Co.* v. *F.E.R.C.*, No. 77-2613, *et al.*, 580 F.2d 722 (5th Cir. 1978).

[24] Shortly after the District Court rendered its decision, Northwest entered into settlement agreements with the PLA interest owners. The agreements mirrored the terms of settlement agreements which El Paso and the GLA interest owners had executed in October 1974. Both pipelines agreed, during the pendency of litigation about the jurisdictional status of the lease-sale contracts, to pay overriding royalties at a rate keyed to, but slightly less than, the regulated ceiling price for new San Juan Basin gas. The outcome of this proceeding (including judicial review of the Commission's action) is to control the rights of the interest owners to retain the funds. In an order issued February 16, 1977, 57 FPC 989, the Commission permitted El Paso to pass through to its customers the cost of the higher

Meanwhile, the administrative hearing went forward. At first, plans were made for trial of all issues, including the question of the remedy that would be appropriate if the lease-sale agreements were ultimately held to constitute jurisdictional wellhead sales of natural gas. In an order issued February 13, 1978, 2 FERC ¶ 61,124, however, the Commission directed that the proceeding should be phased, so that the question of the Commission's jurisdiction over the agreements would be litigated and decided first, with the remedial issue pretermitted until after the jurisdictional question was decided.[25]

The hearings on the jurisdictional issue got underway on May 2, 1977. At an early stage of the proceedings, all parties concerned agreed to stipulate that issues once litigated in the District Court in Midland would not be retried, and that the evidentiary record in the District Court case would be received in evidence in this proceeding and would be the basis for the Commission's disposition of the jurisditional issues between the parties to this proceeding who were also parties to the Midland case. This stipulation saved a great deal of time and effort. Nevertheless, the hearing into the disputes which were not the subject of the Midland litigation consumed 19 days of hearing sessions beginning on May 2, 1978 and ending on June 6, 1978. All parties filed proposed findings of fact and responses to proposed findings of fact on July 3, 1978 and July 25, 1978, respectively. Simultaneous initial briefs were filed on September 11, 1978, and reply briefs were filed on September 29, 1978.

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overriding royalty payments. As of the date this record closed, Northwest had been authorized two rate increases, of $27 million and $34 million, to recover its expenditures for increased overriding royalties.

[25] *El Paso Natural Gas Co.*, Docket No. CP74-314, *et al.*, Order Granting Motion for Phasing of Proceedings and Deferral of Procedures Concerning Remedy, issued February 13, 1978.

III

The first of the lease-sale agreements in the San Juan Basin was GLA 32, entered into in 1950 between El Paso and Delhi Oil Corporation (Delhi). Examination of the history of that transaction is basic to an understanding of why the parties to that agreement, and the balance of the lease-sale agreements, chose to do business in the hybrid lease-sale format rather than through conventional wellhead-sale contracts.

El Paso had been interested in the San Juan Basin as a source of gas supply for several years before GLA 32 was consummated. To supply its first pipeline to California, El Paso had relied almost exclusively on casinghead gas produced in the Permian Basin. This source of supply proved to be unsatisfactory. Casinghead gas, being a by-product of oil production, was produced only as oil was produced. The schedule for oil production was, to a large extent, a function of state prorationing orders and the market's demand for petroleum products, chiefly motor vehicle gasoline. Oil production tended to be most plentiful at the beginning of each month, when producers sought to meet their "allowables" and during the warm weather months, when highway travel was heaviest. These peak periods of oil—and casinghead gas—production did not coincide with the times when demand for natural gas was high in El Paso's markets.

In addition, there simply was not enough natural gas available to El Paso from its Permian Basin sources. In the mid-1940's, it became clear to the pipeline and the California utilities it served that the rapidly expanding California market's demand would soon outstrip El Paso's existing dedicated reserves. The Federal Power Commission, too, was putting pressure on El Paso to secure dedication of new and substantial reserves of dry gas, free from the vagaries of oil production.

As a result of these factors, El Paso undertook a search for a large dry gas supply. The search eventually centered in the San Juan Basin, where gas had first been produced, though not in commercial quantities, as early as the 1920's. The San Juan

Basin's relative proximity to El Paso's California market made it particularly attractive to the pipeline.

Delhi, an independent producer, owned substantial reserves of natural gas in the Barker Dome Field of the San Juan Basin. Like other independent producers operating in the Basin, Delhi was unable to market its gas because no interstate pipeline had reached the Basin, and local demand could not absorb the existing potential supply. El Paso proposed to fill the need for an interstate pipeline connecting the Basin to major metropolitan areas. On August 25, 1947, it filed an application with the FPC, seeking a certificate of public convenience and necessity for construction and operation of a pipeline from the San Juan Basin to a point on the Arizona-California border near Needles, California.

Delhi and El Paso executed a gas-purchase contract dated May 1, 1948. Under the contract, Delhi was to sell and El Paso agreed to purchase up to 100,000 Mcf of natural gas per day for a period of 25 years, and from year to year thereafter, at a base price of ten cents, with a specified escalation of the price of each two and one-half years for the first 15 years of the contract.[26] After the first 15 years, and at five-year intervals thereafter, the price would be set at the fair market value of the gas at the wellhead. It is a measure of the times that the parties set a 13-cent-per-Mcf floor on the fair-market-value figure to be employed under this redetermination clause.[27]

By its terms, the contract would not become operative until two events occurred. Both involved the Federal Power Commission. First, El Paso would have to obtain favorable action from the FPC upon its application for certification of its pipeline project, an application which it had filed nearly nine months earlier. Second, Delhi would have to obtain from the

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[26] Exh. 40 EP 2, pp. 15, 17, 25. For the first ten years of the contract, the price was to escalate one-half cent per year; the price was to escalate one cent per year during the remaining five years.

[27] *Id.* at 25.

Commission a ruling that its performance under the contract would not make the company a jurisdictional natural-gas company.[28]

On May 19, 1948, El Paso and Delhi entered into a second contract which called for both of them jointly to construct, own, and operate the pipeline from the Basin to California that was the subject of El Paso's pending application to the FPC. Thereafter, on June 30, 1948, the San Juan Pipe Line Company, a newly-formed corporation owned by El Paso and Delhi, filed an application with the Commission for a certificate authorizing it to construct, own, and operate a pipeline from the San Juan Basin to California.

The plan, under which the parties would jointly own and operate the pipeline that would, in turn, enable them to market a supply of natural gas to be sold under a relatively conventional gas sale contract, came a cropper, however. The critical problem was Delhi's inability to secure from the Commission a declaratory order, ruling that its performance under the contracts would not subject it to regulation by the Commission under the Natural Gas Act. Three times it sought such a ruling, and three times the Commission refused to issue one.[29]

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[28] *Id.* at 3-5. The contract also required Delhi, *inter alia*, to commit its Barker Dome acreage to the substantial performance of its contractual obligations, to drill wells (within the limits of state spacing restrictions) sufficient to supply the contract volumes of gas, to gather and treat the gas (reserving to Delhi the right to remove hydrocarbons other than methane), and to deliver pipeline-quality gas to a central point on the proposed pipeline. In addition to the above-described pricing provisions, the contract had a favored nations clause.

[29] *Delhi Oil Corp.*, 8 FPC 613 (1949); *Delhi Oil Corp.*, 7 FPC 1025 (1948); *Delhi Oil Corp.*, 7 FPC 958 (1948). The problem, in those pre-*Phillips* days, evidently inhered in Delhi's participation in the pipeline-ownership-and-operation project. In the two later applications, Delhi proposed to restrict, though not completely terminate, its participation and interest in the San Juan Pipe Line Company. The Commission, nevertheless, apparently felt that an independent

As a result, El Paso and Delhi abrogated their contract to construct the pipeline and entered into a new and substantially modified gas-purchase contract. Under the new gas-purchase contract, dated February 4, 1949, El Paso was entitled to call upon Delhi to supply up to 150,000 Mcf of gas per day to meet its peak loads. The second contract, like the first, was conditioned upon an FPC determination that Delhi would be free of regulation under the Natural Gas Act.[30] This time the pipeline to California was to be constructed, owned, and operated by El Paso, without any participation or assistance from Delhi. These terms were evidently satisfactory to the Commission, for on March 10, 1949, it issued an order in which it determined that Delhi would not become a regulated natural gas company by virtue of its performance under the second gas-purchase contract.[31]

While all of this was going on, the larger question of the amenability of independent producers to regulation under the Natural Gas Act was being loudly debated in several forums. There is no doubt about the fact that Delhi, like many other independents, was concerned about the prospect of FPC regulation and was anxious to take whatever steps were feasible to avoid the spectre of jurisdictional status.

In June of 1947, the Supreme Court of the United States, noting that the Commission had not asserted jurisdiction over wellhead sales *per se*, had commented: "We express no opinion

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producer's affiliation with, and co-ownership of, a jurisdictional pipeline could render the producer jurisdictional. To Delhi, a holding that it was jurisdictional would bring down upon it two undesirable consequences: cost-of-service treatment of its gas sales and a regulated rate of return. Once Delhi divested itself of all interest in the pipeline company, however, the law as it then existed placed no impediment in the path of the Commission's issuance of a nonjurisdictional status determination.

[30] Exh. 40 EP 6, pp. 7-8, 22-23.

[31] *Delhi Oil Corp.*, 8 FPC 750 (1949).

as to the validity of the jurisdictional tests employed by the Commission in these cases."[32] Since the issue in the *Interstate* case was the Commission's jurisdiction over a sale by a pipeline, not its jurisdiction over an independent producer's sale, it was unusual and ominous for the Court to reach out to comment on the jurisdictional status of wellhead sales by such producers. Soon thereafter, the Commission issued Order No. 139,[33] adding to its General Rules a new Section 2.54, which purported to exempt wellhead sales by independent producers to interstate pipelines from FPC jurisdiction.

Presumably, the Commission's issuance of the new Section 2.54 was designed to eliminate any doubt about the status of independent producers that may have been engendered by the Supreme Court's comment in the *Interstate* case. The matter would not die that readily, however: On October 28, 1948, the Commission launched an investigation to determine whether Phillips Petroleum Company, an independent producer, had become a jurisdictional natural-gas company by virtue of its wellhead sales of natural gas to an interstate pipeline.[34] In addition, on May 11, 1949, two months after Delhi received its favorable ruling from the Commission, Chairman Nelson Lee Smith of the FPC sent a letter to Arizona Senator Carl Hayden, in which Smith indicated that Delhi's proposed wellhead sale of natural gas to El Paso might subject Delhi to regulation by the Commission.[35] At this time, there was pending in Congress a bill which would have amended the Natural Gas Act to grant independent producers specific legislative

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[32] *Interstate Natural Gas Co.* v. *F.P.C.*, 331 U.S. 682, 690 n.18 (1947).

[33] 12 F.R. 5585 (1947).

[34] *Phillips Petroluem Co.*, 7 FPC 983 (1948). Between the date Section 2.54 was issued and the date the *Phillips* investigation began, Commissioner Richard Sachse had resigned and had been replaced by Commissioner Thomas C. Buchanan.

[35] Exh. 40 EP 1720.

exemptions for their wellhead sales to interstate pipelines, in effect enacting as a statute Section 2.54 of the Commission's General Rules.

After it became aware of Chairman Smith's letter to Senator Hayden, Delhi sought clarification of its status from the Commission.[36] The Commission replied that, inasmuch as Delhi's status turned on the answer to a question of law, *i.e.*, the legal effect of Order No. 139, promulgating Section 2.54 of the Commission's Rules, "The Commission is unable, in the circumstances, to express a conclusive opinion as to whether you will or will not be subject to regulation under the Natural Gas Act by virtue of proposed sale of natural gas to El Paso."[37] Chilling words indeed!—indicating that the Commission's confidence in the legal validity of § 2.54 was beginning to ebb. This development, coupled with other rapidly moving events on the jurisdictional front (*e.g.*, the ongoing *Phillips* investigation), caused Delhi to seek the advice of counsel on other ways to carry out the objectives of its agreement with El Paso without subjecting itself to the risk of regulation under the Natural Gas Act.

Delhi's counsel in Dallas sought the advice of Charles V. Shannon, a Washington lawyer specializing in FPC law and the Commission's one-time General Counsel. In a letter of December 1, 1949, Shannon expressed the opinion that if Delhi, instead of going through with its then-pending wellhead sale contract with El Paso, were to transfer its Barker Dome reserves through a sale of the underlying leases, the transaction would be non-jurisdictional and would not make Delhi subject to regulation by the Federal Power Commission.[38] In light of

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[36] *Id.*

[37] Exh. 40 EP 1721.

[38] Exh. 40 EP 22. Shannon's opinion was based upon the then-recent decision of the Supreme Court in *F.P.C.* v. *Panhandle Eastern Pipe Line Co.*, 337 U.S. 498 (1949), holding that the Natural Gas Act did not apply to the transfer of leases by an interstate pipeline to a production company. It should be noted that Shannon's opinion was

Shannon's opinion and the confusion surrounding the legal status of independent producers, the parties decided to renegotiate and recast the second gas-purchase contract in the form of a lease-sale agreement. Under the lease-sale format, Delhi would sell its gas leases covering the Barker Dome acreage to El Paso, and El Paso would undertake the production of natural gas from the acreage. Delhi would receive compensation for the gas in an amount roughly equivalent to the per-Mcf price it would have received under the gas-purchase contract, minus El Paso's production costs.

The most significant factor in the arrangement was this: the lease-sale format was developed specifically for the purpose of putting the independent producer and the pipeline in about the same economic positions they would have enjoyed under a conventional wellhead gas sale contract. From the standpoint of the parties to the first lease-sale agreement, the primary purpose—and perhaps the sole purpose—of using that format rather than a conventional wellhead gas sale contract was to avoid the possibility that independent producers who sold their gas to interstate pipelines under such a contract would be held to be natural-gas companies subject to the Federal Power Commission's regulatory jurisdiction.

El Paso and Delhi abrogated the second gas-purchase contract on January 27, 1950. On the same day, they entered into a lease-sale agreement, which El Paso later designated GLA 32. The agreement provided that El Paso would pay to Delhi an "overriding royalty" on all gas produced from the Barker Dome acreage. The amount of the payment was to be five cents per Mcf for the first five years, six cents per Mcf for the next five years, and seven cents per Mcf for the ensuing five years;

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rendered five years before the Supreme Court held, in *Phillips Petroleum Co.* v. *Wisconsin*, 347 U.S. 672 (1954), that wellhead sales by independent producers were jurisdictional and 16 years before the *Rayne Field* case, *supra*, held that the sale of a lease may be the legal equivalent of a jurisdictional sale of natural gas.

thereafter, the seven-cents-per-Mcf price would remain in effect until cumulative production taken from the acreage by El Paso reached 600 Bcf, after which the "royalty" would be equal to the fair market value of the gas (but not less than 7¢ per Mcf).[39] Delhi reserved all rights to any oil production. The agreement called for El Paso to make a substantial cash down payment, which could be increased or decreased in the future depending upon the parties' recalculation of the gas reserves underlying the acreage. El Paso was entitled to take a maximum of 110,000 Mcf per day; under the take-or-pay clause, it was obligated to take a minimum of 60,000 Mcf per day.[40] The lease-sale agreement, like its predecessor contracts, was contingent upon FPC issuance of the certificate to construct a pipeline and transport San Juan Basin gas to California markets. That contingency was satisfied on July 4, 1950, when the Commission issued the certificate to El Paso.[41] One year later, in July 1951, El Paso began the transportation to California of natural gas produced from the Barker Dome Field.[42]

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[39] Exh. 40 EP 29.

[40] *Id.* at 9-10. Under a "take-or-pay" clause, the putative lessee was obligated to pay for a specified minimum volume of gas production from the acreage, regardless of whether that volume of gas was actually produced and taken into the pipeline. The effect of the clause, in the context of a lease-sale agreement, is to prevent the lessee from shutting in production from the acreage covered by the agreement, thereby limiting its financial obligation and depriving the lessor of revenue.

[41] *San Juan Pipe Line Co.*, 9 FPC 170 (1950).

[42] Congress eventually passed the bill exempting well-head sales by independent producers from Federal regulation under the Natural Gas Act. On April 15, 1950, President Truman vetoed the measure. Shortly thereafter, on July 11, 1950, the Commission issued Order No. 154, 15 F.R. 4633 (1950), rescinding Section 2.54 of its General Rules on the ground that the administrative exemption of wellhead sales by independent producers to interstate pipelines was inconsistent with the Natural Gas Act.

IV

One of the most bitterly contested issues in this case concerns the extent to which the gas-producing potential of the San Juan Basin was fully known at the time El Paso began its program of acquiring leases in the Basin. Although a great deal of time and attention has been devoted to the geology of the San Juan Basin and its prospects from a business and economic standpoint, the essential facts can be summarized in relatively brief compass.

Large volumes of natural gas underlie the San Juan Basin, and geologists and petroleum engineers were generaly aware of this fact as early as 1950, when GLA 32 was signed.[41] The gas occurs principally in three sandstone formations: 1. The Pictured Cliffs formation, the shallowest of the three; 2. The Mesaverde formation, the primary focus of developmental activities, consisting of two distinct pay sands, the Cliff House and the Point Lookout, separated by the non-gas-bearing Menafee formation; and 3. The Dakota formation, the deepest of the three.[44] The three formations share certain similarities. All are of varying depths and thicknesses. Each of the formations consists of blanket, gas-bearing sands which are deepest towards the center of the Basin and outcrop progressively at the Basin's perimeter.[45] All of the gas-bearing formations are characterized by relatively low porosity and permeability.[46] Because of the low porosity and permeability of the pay sands, it was well known that the gas of the San Juan Basin would be relatively expensive to extract, and that a producer would have to wait longer to recover his investment in a San Juan

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[41] See *e.g.*, Exh. 40 EP 1920.

[44] Exh. 38, III J.A. 552a-554a, 557a.

[45] Exh. 38, III J.A. 554a; Exh. 40 EP 1905(A)(2), p. 3; 40 EP 1905(F)(1), pp. 3-4; 40 EP 1905(F)(1), pp. 4-5.

[46] Exhs. 38, III J.A. 553a-554a, 576a; 40 EP 1905(A)(2), p. 4; 40 EP 1920, p. 119.

Basin well than he would have to wait for payout from a well drilled elsewhere. Counterbalancing these factors was the blanket nature of the sands, a phenomenon which tended to assure that gas would be encountered at virtually any location.[47]

In the early 1950's, DeGolyer & MacNaughton (D&M), a respected, well-known firm of oil and gas geologists, made numerous studies and evaluations of the natural gas reserves of the San Juan Basin. D&M concluded that reserves of natural gas were available in sufficient quantities to warrant commercial production activities.[48] Using the volumetric method of estimating, D&M expressed great confidence that large volumes of natural gas were available for extraction from virtually all of the San Juan Basin acreage that the firm studied. For example, in a January 1, 1950 report presenting "an estimate of the proved recoverable reserves from the lower Paradox limestone formation in the Barker Creek Gas Field * * * and certain acreage under dedication to El Paso Natural Gas Company,"[49] D&M concluded that—

> This reservoir is estimated to contain 2 trillion 294 billion 272 million cubic feet of gas in place within an area of 45,000 acres.
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> * * * * * *
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> The indicated original reserve in place per acre for the entire field is 50 million 983 thousand cubic feet per acre.
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[47] A witness for Northwest testified that, having drilled several hundred wells in the Basin, the pipeline had never had a dry hole. Tr. 765.

[48] See, *e.g.*, Exhs. 40 EP 1905(A)(1), (A)(2), (C)(2), (C)(9), (E)(2), (E)(4), (F)(1), (F)(2).

[49] Exh. 40 EP 1905(A)(1), p. 1.

> The remaining gas reserves of the field recoverable to a terminal pressure of 250 psig shut-in wellhead after deducting the cumulative production to January 1, 1950 is 2 trillion 88 billion 743 million cubic feet.
>
> The gas reserve available for pipeline sale after making allowances for miscellaneous field use, treating losses and fuel, recoverable to a terminal pressure of 250 psig shut-in wellhead is 1 trillion 531 billion cubic feet.[20]

This language, it should be noted, pertains to only one set of leaseholds in the Basin. D&M was similarly sanguine about the abundance of proved reserves underlying other acreage that it studied.

The respondents now claim that D&M's use of the "volumetric" method of calculating reserves in place, rather than the more precise "pressure decline" method, resulted in gross overestimates on D&M's part. They also quibble about D&M's use of the term "proved reserves" in the firm's several reports; respondents claim there is a difference between that term as D&M used it and the "proved reserves" that must be present before a sale of a leasehold will be construed as a sale of gas in place under the teachings of *Rayne Field* and its progeny. Both of these contentions are rejected. In the first place, respondents' criticisms are palpably the product of litigation-inspired 20/20 hindsight. So far as this record shows, all of the contemporaneous, knowledgeable, interested persons who reviewed the D&M reports placed complete confidence in their accuracy for the purpose for which they were made; the FPC, for instance, certificated a major new pipeline system based upon the reserve estimates produced by D&M.

In the second place, it is doubtful that either *Rayne Field* or any of the cases that have expounded upon the *Rayne Field* doctrine demand that proven reserves be defined with the hairsplitting nicety upon which the respondents seem to insist. All that *Rayne Field* requires is that the parties know and

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[20] *Id.* at 4-5.

believe there is at least a specified quantity of gas in place upon which they can rely for the purpose of transacting business.

Thirdly, while the volumetric method is admittedly less accurate than the pressure decline method, the difference is not substantial when we are dealing with an area as great, and volumes as large, as those the San Juan Basin presented. Furthermore, the volumetric method of estimating reserves is today, and was then, a sound, generally-accepted technique for estimating gas reserves, especially in a field with little or no production history.[31] This is not, moreover, a case of preferring a faulty methodology over an exact and precise one. As counsel for Atlantic Richfield, one of the respondents, pointed out during the Midland trial, "reserve estimating is at best an inexact science."[32]

Finally, as noted above, the record shows that, contemporaneously with the D&M studies and thereafter, all of the parties acted on the assumption that there were massive quantities of proved reserves underlying the San Juan Basin. The most persuasive point is that, notwithstanding the above-average costs of extracting the San Juan Basin's gas reserves,[33] experienced and knowledgeable businessmen were willing to expend huge sums of money to obtain rights to the gas reserves of the Basin.

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[31] See Exh. 38, IV J.A. 1218a-19a.

[32] *Id.* at 1219a. To which the witness responded, "I think that's a good classification, yes, sir."

[33] Several of the factors that caused the cost of extracting gas from the Basin to exceed the cost of comparable development activities elsewhere in the Southwest have been noted above. There was the low permeability and porosity of its gas-bearing sandstone formations, coupled with the unusually low pressure of the gas reserves. In addition, the relative isolation of the Basin and the lack of a local gas-technology infrastructure, *e.g.*, skilled drillers and equipment suppliers, made the cost of development operations higher than would have been the case in, say, the Permian or Hugoton Basins.

Delhi and other independent producers (some of whom are now before the Commission in this case, taking the view that the Basin was a risky speculation), all successful and profit-oriented business concerns, acquired leases on much of the Basin's acreage and were willing to agree to delay-rental obligations for failure to develop the leases. Delhi had in fact executed two contracts with El Paso, under which it was obligated to make wellhead sales of the reserves underlying its acreage. Although the contracts were aborted, the problem was not a lack of confidence in the estimates of the Delhi reserves. Similarly, El Paso risked the vast sums that went into the construction of the San Juan pipeline on the belief that its acquisitions in the Basin included enough reserves to support that investment. The Commission, too, must have been convinced of the virtual certainty of the reserves; it certificated the pipeline on that basis. And D&M, then as now one of the most prestigious engineering consulting firms in the nation, had staked its professional reputation on its evaluation.

At that time, before the significance of the question for purposes of litigation became known, all of the knowledgeable persons in the field acted upon the assumption that large volumes of proved reserves could be produced from the San Juan Basin. It is too late now to suggest that the contrary was true.

V

As we have seen, use of the lease-sale format as the mechanism for transferring reserves began with GLA 32, which was executed early in 1950. GLA 32, however, is not involved in this proceeding, and is substantially different in content from the El Paso lease-sale contracts that were executed later. The basic terms and conditions that recur again and again in the lease-sale contracts involved in this proceeding first appeared in GLA 47, signed in January of 1952. It seems clear that the contents of GLA 47 set the pattern for the rest of the San Juan Basin GLA contracts. For this reason, it is worthwhile to look into the reasons why GLA 47 came into being.

Once again, the fundamental stimulus was California's seemingly insatiable hunger for natural gas. As the demands of the California market increased, El Paso was once again confronted with the urgency of obtaining new gas supplies in order to maintain its position as California's primary gas supplier. On March 6, 1951, El Paso had filed an application with the Federal Power Commission, seeking a certificate authorizing the transportation of an additional 100,000 Mcf of gas per day from the San Juan Basin to the California border.

By early 1951, Delhi had acquired huge reserves of natural gas in the Blanco-Largo and Kutz Canyon-Angel's Peak Fields of the San Juan Basin, both of which were located to the Southeast of the Barker Dome Field. It was clear to El Paso that, in order to support its pending FPC application to increase its natural gas service, it would have to obtain dedication of the vast Delhi reserves to the El Paso system. This was the case for two reasons. First, the Delhi reserves were uniquely large enough to provide the volumes needed to support the application. Second, the unique strategic location of the Delhi reserves permitted them to be rapidly introduced into El Paso's pipeline system, thereby providing the deliverability that El Paso needed to demonstrate to the Commission.

El Paso at first attempted to purchase the gas from Delhi at the wellhead. It offered an initial base price of 7.33 cents per Mcf plus longevity escalations. Delhi rejected the offer on the ground that the price was too low. El Paso then approached other independent producers in the area, seeking to make wellhead sales contracts. But those producers, aware of El Paso's urgent need for the dedication of new reserves and of Delhi's strong bargaining position, refused to consummate sales to El Paso until the outcome of the negotiations with Delhi became known. Hence, El Paso was forced to deal with Delhi first. Unable to obtain the gas reserves it needed through the medium of conventional wellhead sale contracts, El Paso sought to purchase Delhi's leases in a transaction similar in form to the Barker Dome sale that had taken place in 1950.

After months of hard bargaining, the parties executed the lease-sale agreement now known as GLA 47 on January 18, 1952.[54]

GLA 47 covered leases owned by Delhi in the Blanco-Largo Field of the San Juan Basin. In the contract, Delhi agreed to assign its entire interest in the leaseholds to El Paso, reserving an "overriding royalty" on all gas produced and saved from the subject acreage. The *quantum* of the "overriding royalty" was fixed as follows:

5½¢ per Mcf for the first 3 1/3 years from date of closing.

6½¢ per Mcf for the next 3 1/3 years thereafter.

7½¢ per Mcf for the next 3 1/3 years thereafter.

Not less than 8¢ per Mcf for 1 year thereafter.

Not less than 9¢ per Mcf for 1 year thereafter.

Not less than 10¢ per Mcf thereafter.[55]

The agreement also provided for redetermination of the price after the tenth year and after each ensuing five-year period. If the parties were unable to reach agreement as to the new price, the issue would be settled by arbitration, with the arbitrators fixing the price at the fair market value of the gas at the wellhead (but not less than the minimum figures set forth above). The agreement also contained a favored nations clause.

In addition to its "overriding royalties" on gas production, Delhi also retained substantial rights in other minerals. Delhi reserved a 33 1/3% interest in all liquid hydrocarbons extracted from the acreage, and it had the option to require El Paso to pay the override in kind or in cash at the fair market value of the liquids. Delhi reserved the rights to any oil recovered from the leasehold. Delhi also retained the rights to all gas or other

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[54] The negotiations were conducted by two now-legendary figures in the industry, Clint Murchison, President of Delhi and Paul Kayser, President of El Paso.

[55] Exh. 24, p. 5.

hydrocarbons taken from any formation deeper than the Mesaverde.

The agreement also contained a take-or-pay clause, which required El Paso to pay for a minimum volume of gas production from the leasehold, whether or not it took that quantity.[36] It imposed a number of specific drilling and developmental obligations upon El Paso, such as the obligation to develop the acreage fully down through the Mesaverde and all shallower formations and to drill at least one well on each 320-acre spacing unit during the first five years after execution of the contract. El Paso also undertook complete responsibility for operation of the acreage, including the actual production of gas from it. In the contract, El Paso agreed to pay Delhi for wells located on the acreage at the date of closing. The price was $80,000 for each completed commercial Mesaverde well and $20,000 for each completed commercial Pictured Cliffs well.

El Paso was given the right to reassign acreage to Delhi, and thereby to be relieved of responsibility to develop the acreage, if it appeared that a specific production unit would not produce gas in commercial quantities. In addition, El Paso had the right to reconvey to Delhi any specific well that proved to be unprofitable to operate; Delhi then had the option to continue production from the well, selling the gas to El Paso at the wellhead at the highest price prevailing in the field. Finally, the agreement provided that Delhi had the option to purchase, at El Paso's cost, any oil well El Paso might complete.

The question whether the GLA 47 transaction would render the seller subject to FPC jurisdiction apparently remained

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[36] The clause (Article VII, Section 1) was somewhat ambiguous. It set the take-or-pay quantity at all gas produced from the acreage until total production exceeded 100,000 Mcf per day. Thereafter, El Paso was obligated to take or pay for the greater of 25% of the open flow capacity of all the wells, on the basis of an 80% load factor, but not more than 150,000 Mcf per day, or 100,000 Mcf of gas per day until the acreage was fully developed and 25% of open flow capacity up to 150,000 Mcf per day thereafter. In any event, the minimum daily takes could be averaged out over a one-year period.

uppermost in the minds of Delhi's principals, for they sought another legal opinion on that subject shortly before the agreement was executed. On January 7, 1952, eleven days prior to the signing of GLA 47, Delhi's counsel, Charles V. Shannon, issued another opinion, in which he reiterated his view that consummation of this particular lease-sale agreement would not make the transaction jurisdictional under the Natural Gas Act.[57]

GLA 47 was closed on March 1, 1952. On that date, Delhi assigned its leases and wells to El Paso and El Paso paid Delhi $1,020,941.34 for Mesaverde and Pictured Cliffs wells situated on the acreage covered by the agreement.[58] Shortly after the closing, during March 1952, El Paso began to transport gas produced from the GLA-47 acreage through its interstate pipeline system.[59] Three months later, on June 19, 1952, the Federal Power Commission granted El Paso's application for a certificate authorizing the expansion of its facilities.[60]

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[57] It is significant that Shannon's opinion was issued about a month after the parties had signed a memorandum agreement, dated December 5, 1951, outlining the significant terms of the contemplated lease-sale agreement. They evidently believed that the deal could have been aborted if counsel subsequently advised that there had been a shift in the jurisdictional winds.

[58] CPFF (Complainants' Proposed Findings of Fact) No. 116, p. 43; See also Exh. 24 (Letter from Delhi Oil Corp. to El Paso Natural Gas Co., dated February 29, 1952, re: Delhi-El Paso Trade, pp. 1-4. It should be noted that the parties considered the wells to be sufficiently commercial to fall within the contract requirement that El Paso must pay Delhi only for commercial wells. See Exh. 24, p. 10.

[59] CPFF No. 118, p. 43.

[60] *El Paso Natural Gas Co.*, 11 FPC 1071. The Commission also removed a 34 Bcf annual ceiling on volumes transported through El Paso's system. The ceiling had been imposed when the El Paso pipeline from the San Juan Basin was originally certificated.

At present, the interest owners of GLA 47 (successors to Delhi's rights) are Tenneco Oil Company and Continental Oil Company. Both of these companies have demanded increased overriding royalty payments from El Paso. Both Tenneco and Continental were parties to the U.S. District Court suit in Midland, Texas.

VI

It was as if the execution of GLA 47 had broken a logjam.

After the March 1, 1952 closing of GLA 47, El Paso's program of acquiring gas reserves in the San Juan Basin through purchases similar to the so-called "Delhi deal" proceeded rapidly. In all, the pipeline made 36 lease-sale contracts with the owners of gas leaseholds in the Basin, thereby acquiring the gas underlying more than a quarter of a million acres.[61]

Although it took some six and one-half years to consummate all of the agreements, the large tracts were acquired early in the program. Almost two-thirds of the acreage (some 65.6% of it) was under contract by January 1953, a year after execution of the first GLA, and the contracts for more than 80% (82.5%) of the acreage had been signed by July 8, 1953, some 18 months after GLA 47 came into being.

The essential details of the GLA acquisitions are provided in the following table:

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[61] Only 35 of the GLA contracts are implicated in this case. The exception is GLA 153, which is shown on Exhibit 36 as having been executed on May 10, 1953. Francis I. Harvey is identifed as the interest owner. For reasons which are not presently apparent, the Commission did not designate the GLA 153 interest owners as respondents when it initiated this case. See Tr. 412.

GLA No.	*Date Signed*	*Date Closed*	*Original Owner*	*Present Owner*	*Prior Gas Purchase Contract*[d]
47	1/18/52	3/1/52	Delhi Oil Corp.	Tenneco Oil Co. & Continental Oil Co.	No
51	2/29/52	3/1/52	J. Glenn Turner	Mapco Production Co. & Hopi Oil Co.	Yes
52	4/19/52	5/16/52	Three States Nat. Gas Co.	Tenneco/Conoco	Yes
60	9/26/52	1/22/53	San Juan Drilling Co., *et al.*	Tenneco/Conoco	No
61	9/26/52	1/5/53	Sunray Oil Co.	Sun Oil Co.	No
62	10/10/52	3/18/53	Blackwood & Nichols Co.	F.H.N., Ltd.	No
63	1/23/53	2/20/53	Atlantic Refining Co.	Atlantic Richfield Co.	No
66	3/31/53	4/24/53	Lucerne Corp.	W. Watson LaForce, *et al.*	No
72	6/2/53	7/15/53	J. Glenn Turner	Mapco/Hopi	Yes
76[a]	7/6/53	1/4/54	Johnston Oil and Gas Co.	Union Oil Co. of Cal.	No
77[a]	7/6/53	1/3/54	R. E. Beamon	Robert Beamon, *et al.*	No
78	7/8/53	7/27/53	Three States & Albuquerque Ass'd. Oil Co.	Tenneco/Conoco, Am. Petrofina, *et al.*	No
86	12/1/53	12/1/53	J. Glenn Turner	Mapco/Hopi	Yes
101	4/2/54	4/2/54	J. Glenn Turner	Mapco/Hopi	Yes
106	5/25/54	7/1/54	Morris Mizel, *et ux.*	Morris Mizel, *et ux.*	Yes
122	10/12/54	12/1/55	White, McMillan & McLane	Producing Royalties, Inc., *et al.*	Yes
125[a]	11/10/54	11/30/56	Benson-Montin, *et al.*	American Petrofina Co.	Yes
127	12/1/54	12/1/54	J. Glenn Turner	Mapco/Hopi	Yes
129	12/24/54	11/30/56	Delta Drilling Co.	Delta Drilling Co., *et al.*	Yes
139	3/3/55	2/1/58	White & McLane	Producing Royalties, Inc. *et al.*	Yes
152[a]	4/1/56	4/1/56	Webb & Turner	Turner & Webb	Yes
157[a]	6/1/55	6/1/55	Turner & Webb	Turner & Webb	Yes
160[a]	7/1/55	7/1/55	Turner & Webb	Turner & Webb	Yes
172	4/29/55[b]	9/24/53[b]	Beaver Lodge Oil Corp.	Crown Central Petroleum Corp.	Yes
195[a]	1/9/56	1/9/56	Turner & Webb	Turner & Webb	Yes
196	12/28/55	12/28/55	Turner & Webb, *et al.*	Turner & Webb, *et al.*	Yes
197	12/28/55	12/28/55	Huerfanito Drilling Co.	Huerfanito Drilling Co.	No

GLA No.	*Date Signed*	*Date Closed*	*Original Owner*	*Present Owner*	*Prior Gas Purchase Contract*[d]
198[a]	12/28/55	12/28/55	Turner, Webb & Schultz, *et al.*	Turner, Webb & Schultz, *et al.*	Yes
231[a]	12/1/55	12/1/55	Turner, Webb & Abraham	Turner, Webb, *et al.*	Yes
248[a]	1/8/57	1/8/57	Turner, Webb & Schultz	Turner, Webb & Schultz	Yes
249[a]	1/8/57	1/8/57	Turner & Webb	Benson-Montin-Greer Drilling Corp., *et al.*	Yes
348*	7/29/58	8/1/58	Texas Nat'l Petroleum Co.	Union Oil Co. of Cal.	No
349**	7/29/58	7/29/58[c]	Texas Nat'l Petroleum Co.	Union Oil Co. of Cal.	No
350*	8/5/58	8/5/58	R. E. Beamon	Robert Beamon, *et al.*	No
351**	8/5/58	9/9/58	R. E. Beamon	Robert Beamon, *et al.*	No

*GLAs 76, 77, 348, and 350 related to the same acreage.

**GLAs 349 and 351 related to the same acreage.

[a]GLAs which were the subject of the case of *William G. Webb, et al.* (Op. No. 642), 49 FPC 17 (1973).

[b]Leases were transferred on September 24, 1953 pursuant to a letter agreement dated July 30, 1953. Formal GLA contract was signed on April 29, 1955.

[c]Exhibits 42 (Rev.) and 36 show closing date as 9/9/58. CPFF No. 432 gives it as 7/29/58.

[d]"Yes" indicates that, prior to the lease-sale, El Paso purchased gas from the acreage under a wellhead sale.

As the table indicates, the number of separate tracts of land involved was somewhat less than the number of GLA contracts. Four of the agreements GLAs 76, 77, 348 and 350, related to the same acreage, with the latter two transactions transferring to El Paso the deeper horizons of the tract. Similarly, both GLA 349 and GLA 351 related to the same acreage, with the first transferring five-sixths of the working interest and the second transferring the remainder.

In the case of almost half the contracts—16 of them—we find that the interest owner who sold the leasehold consisted of J. Glenn Turner, Delhi's General Counsel, one of Turner's partners in the Dallas law firm of Turner, Atwood, White, McLane and Francis, or both.[52] Whether these corporate lawyers were acting for themselves or as agents for others is a question upon which the record offers no enlightenment. Eight of the Webb-Turner GLAs, plus GLA 125, were the subject of the Federal Power Commission's Opinion No. 642.[53]

As the table above indicates, natural gas from the acreage involved had been sold to El Paso under conventional wellhead sale contracts before the Webb-Turner GLA contracts were signed. In order to transfer the leasehold interests, it was necessary for the seller, in each case, to obtain the Commission's approval; technically, the transmutation of the conventional wellhead sale into a sale of the leasehold and its underlying reserves constituted an "abandonment" of the conventional sale, for which authorization was required under Section 7 of the Natural Gas Act.[54] There is, however, no explanation of why the 13 other GLA contracts which replaced prior wellhead sales were not also the subject of abandonment cases.

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[52] Besides Turner, two the firm's partners who turned up as sellers, were William G. Webb and Alfred E. McLane.

[53] *William G. Webb, et al.*, 49 FPC 17 (1973).

[54] 15 U.S.C. 717f.

The following table [see 66a-67a] shows the number of wells on the acreage covered by each of the GLA contracts as of the date the contract was signed and as of the date the property transfer was closed. In some cases, *e.g.*, GLAs 139 and 172, a substantial period of time elapsed between the two dates, during which a substantial number of wells were drilled. The record does not disclose why the lengthy hiatus occurred in some cases and not others. We may infer that, in those instances where the closing was delayed, the seller found it financially attractive to "drill up" his acreage and to sell the wells to El Paso at the price specified in the contract. The table also contains an estimate of the size of the parcel transferred under each of the GLA contracts. In this connection, it should be noted that, during the period of El Paso's lease-sale acquisitions, New Mexico law set a maximum on the number of wells that could be drilled on a tract of a given size. The maximum was one Pictured Cliffs well for each 160 acres and one Mesaverde well for each 320 acres.

The formats of the GLA agreements all followed essentially the same pattern. In exchange for the lessee's agreement to transfer the gas leasehold (either the lessee's interest in all the acreage or only his rights in certain horizons), El Paso agreed to pay a lump sum at the closing to purchase the wells and gas-drilling-and-production equipment located on the acreage. In some cases, there was also a specified lump-sum payment which was not tied to any particular personalty transfer—a sort of "bonus" to the owner of the leasehold.[65]

The principal compensation to the interest owner, however, took the form of periodic payments which were to be made as El Paso produced the gas and other hydrocarbons. The payment was termed an "overriding royalty." In about half the

[Text continues on p 68a, after table]

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[65] In two cases, GLA 63 with Atlantic Richfield and GLA 66 with Lucerne Corporation *et al.*, there were no wells on the acreage, and there was no provision for payment of a lump sum at closing.

GLA No.	*No. of Acres*	*Wells on Date Signed*	*Wells on Date Closed*	*Remarks*
47	102,400	15MV 9PC	16MV 9PC	Only 11 MV and 7 PC wells purchased as "commercial."
51	841.71	3MV 1PC	3MV 1PC	PC well is not shown on Exh. 41, Tab 1 map.
52	29,631.21	6MV 1PC	7MV 1PC	El Paso's Exh. 42 (Rev.) shows 8 MV wells.
60	3,500	1MV	7MV	Exh. 42 (Rev.) shows 8 MV wells. Contra: Exh. 40 EP 40.
61	11,400	3MV	4MV	2 incomplete wells on 1/5/53 closing date.
62	See remarks	2PC	2PC	1,081 acres in initial transfer. 11,520 acres eventually transferred. 1 well not deemed "commercial."
63	5,080	0	0	
66	2,480	0	0	
72	2,443.69	2MV	2MV 13PC	Exh. 42 (Rev.) shows 4 MV wells at closing. Map (Ex. 41, Tab 3) shows only 2 complete.
76	26,687.71	4PC	19PC 3MV	Same acreage as GLAs 77, 348, 350. 1 incomplete PC well at closing.
77	do.	do.	do.	Same acreage as GLAs 76, 348, and 350.
78	10,423.49	2MV	2MV	
86	320	1MV	1MV	
101	800	5PC	5PC	
106	1,480	2MV	2MV	
122	1,280	0	8PC	
125	9,250.25	5PC	49PC	Acreage has only 48 wells today.
127	1,760	6MV 5PC	6MV 5PC	
129	5,286.31	6PC	31PC	
139	3,429.17	0	19PC	Map (Exh. 40 EP 40) shows 2 PC wells on 3/3/55 execution date.

152	1,921.36	12PC	12PC	
157	3,760	24PC	24PC	
160	320	2PC	2PC	
172	1,201	11MV	11MV	GLA confirmed 7/30/53 letter agreement.
195	1,600	10PC	10PC	
196	2,885.30	18PC	18PC	
197	160	1PC	1PC	
198	960	6PC	6PC	
231	480	3FR	3FR	Fruitland (FR) wells were shallower than PC wells.
248	920.69	7PC	7PC	
249	4,720.81	1MV	1MV	
		32PC	32PC	
348	26,687.71	2DK	2DK	Same acreage as GLAs 76, 77, and 350. GLAs 348 and 350 transferred Dakota formation rights.
349	1,283.48	5PC	5PC	Exhs. 42 (rev.) and 36 show closing date as 9/9/58. CPFF (p. 110) says 7/29/58.
350	26,687.71	2DK	2DK	Same acreage as GLAs 76, 77, and 348. GLAs 348 and 350 transferred Dakota formation rights.
351	1,283.48	5PC	5PC	Same acreage as GLA 349.

Total acreage = 250,226.78

cases (17), the royalty was payable as long as gas was produced from the acreage. In the remainder, the royalty went to liquidate El Paso's obligation to make a lump-sum "production payment." Since the amount of the "production payment" was usually calculated on the basis of the maximum volume of reserves thought to underlie the acreage, it made very little practical difference which form the obligation took.

Under the typical arrangement, El Paso's initial payment was pegged at between five and six cents per Mcf. During most of the period, the wellhead price of gas in the Basin hovered between ten and twelve cents per Mcf, and the cost of production was thought to vary between five and seven cents per Mcf. Hence, the initial price, in many cases, closely approximated a fair estimate of the profit after production expenses that could have been anticipated from a wellhead sale. The initial payment escalated, usually by one cent per Mcf, at specified intervals until the agreement was either ten years old (in the case of the Turner, Webb-Turner, and GLA 47 agreements) or 15 years old (in the case of all the other agreements). Thereafter, the price was to be the wellhead value of the gas, fixed by mutual agreement or, failing that, by arbitration at five-year intervals, but not less than the last specified escalation.

For example, the compensation provisions of one contract (GLA 52) provide, in Article III, Section 2, that the interest owner, Three States Natural Gas Company, "reserves and retains to itself and its successors and assigns, or to person(s) whom Three States may designate, the following:

Paragraph A. An overriding royalty on Three States' interest in all gas produced and saved from the said leases and the subject lands being sold herein as follows:

(1) 5¢ per Mcf on all such gas produced and saved during the first 3 1/3 years after the date of closing.

(2) 6¢ per Mcf on all such gas produced and saved during the next 3 1/3 years thereafter.

(3) 7¢ per Mcf on all such gas produced and saved during the next 3 1/3 years thereafter.

(4) 8¢ per Mcf on all such gas produced and saved during the next one year thereafter.

(5) 9¢ per Mcf on all such gas produced and saved during the next three years thereafter.

(6) 10¢ per Mcf on all such gas produced and saved during the next one year thereafter.

(7) Not less than 10¢ per Mcf on all such gas produced and saved thereafter.[66]

The GLA 52 contract went on to provide that, when 15 years have elapsed from the date of the closing, the parties would attempt to agree on the amount of the overriding royalty for the ensuing five-year period, and that the agreed figure would be at least the ten-cents-per-Mcf final price specified in the above-quoted schedule. In the absence of mutual agreement, the contract said,

> such amount shall be determined by a board of arbitrators * * *. The board of arbitrators, in determining the amount of an overriding royalty, shall base their decision on the then value of such gas at the well head, considering only quality and pressure of gas, aggregate quantity of delivery and the then current field prices (of then newly negotiated contracts) of gas in other fields connected to or in the area of any of El Paso's pipe lines or gathering systems * * *.

This process of setting the royalty at the wellhead value of the gas produced from the lease was to be undertaken anew after the twentieth year from the date of closing and at intervals of five years thereafter. In any event, however, the ten-cents-per-Mcf figure was to remain a floor under the amount of the royalty payment.[67]

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[66] Exh. 25, p. 7. The interest of Three States Natural Gas Company is now held by Tenneco Oil Company and Continental Oil Company.

[67] Exh. 25, pp. 7-9. In GLAs 348, 349, 350, and 351, the initial price-redetermination date was fixed at January 1, 1969 and was not measured from the date of contract closing. These exceptions to the general pattern may be related to the fact that those four contracts

In all but one of the agreements (GLA 153), the interest owner reserved an overriding royalty interest in any liquid hydrocarbons (except oil) that El Paso might produce from the horizons transferred to the pipeline. Typically, the overriding royalty was one-third of the seller's interest in the liquids, payable either in cash or in kind at the interest owner's option. The interest owner also specifically reserved all rights to any oil that might underlie the acreage and to all gas or other hydrocarbons in formations not conveyed.

Each of the agreements obligated El Paso to develop the acreage in a manner which would avoid forfeiture of the underlying lease. Also, the agreements expressly or by implication imposed on the pipeline certain minimum requirements to drill new wells and to take gas from existing wells. For example, in GLA 77 and GLA 76, both of which covered the same acreage, El Paso was bound to drill, within seven and one-half years from the date of closing, at least one Mesaverde well on each 320-acre Mesaverde drilling unit and one Pictured Cliffs well on each of the 160-acre Pictured Cliffs drilling units authorized by the New Mexico Oil and Gas Commission. In agreements where there was no specific obligation to drill and produce from new wells to be made at El Paso's expense, the pipeline's obligation to develop was a function of the take-or-pay clause. As is indicated above, that clause required El Paso to take or pay for an annual average of 25% of the aggregate open flow capacity of all the wells on the acreage on the basis of an 80% load factor. This type of clause was generally found in agreements pertaining to acreage that had, at the time of closing, about the maximum amount of wells allowed by State law—so that it was thought unnecessary or futile to provide for additional drilling.

GLA 198, for example, involved the transfer of rights to the gas in the Pictured Cliffs formation underlying one and one-

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involved acreage that had been transferred in prior GLAs. In any event, the interval between redetermination dates provided for in GLAs 348, 349, 350, and 351 was the standard period of five years.

half sections. At the time of closing, there were six Pictured Cliffs wells on the acreage, or one well per 160 acres.[28] Article VII, Section 1 of the contract (entitled MINIMUM GAS PRODUCTION AND DEEP GAS PRODUCTION) provided as follows:

> El Paso agrees that it will promptly commence and continue taking gas from wells now existing or which may hereafter be completed in the zones and/or formations in the leases and operating agreements being sold to it hereunder, subject to the physical capacity of the wells to produce the quantities hereinafter provided for against the line pressures of El Paso's gathering system, and likewise subject to requisite authorization to produce such volumes under the rules and regulations of governmental authorities having jurisdiction thereof, provided, however, that El Paso shall take gas hereunder at natural well head flowing pressures and shall have the right to operate its gathering system at pressures up to, but not exceeding 250 PSIG. * * *
>
> Subject to the foregoing provisions hereof, El Paso shall take from Pictured Cliffs wells now existing or which may be hereafter completed on the subject lands and leases, an amount of gas each day equal to twenty-five percent (25%) of the aggregate open flow capacity of all such wells on the basis of an eighty percent (80%) load factor, averaged annually. In lieu of taking the minimum quantities of gas required by this Agreement, El Paso may pay to each Assignor, in cash, all amounts which would have been due to such Assignor hereunder had such quantities been taken. * * * Any gas paid for by El Paso but not taken during any year by virtue of the minimum take or pay provisions hereof may be taken by El Paso from the subject lands at any time thereafter out of any production in excess of the minimum quantities above provided for during the period or periods in which such quantities are being made up.[29]

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[28] See Exh. 41, Tab 16.

[29] Exh. 16, pp. 19-21.

A number of the GLAs contained a so-called reconveyance clause, a provision which operated to limit El Paso's risks.[70] The clause gave El Paso the right to reassign to the interest owner acreage or wells that proved to be unprofitable or non-commercial, thereby liquidating its obligation to make good on the lessee's duties to the landowner with respect to the acreage or the wells.

A relatively straightforward example of a reconveyance clause, one dealing only with the possibility of an unprofitable well, appears in GLA 106, which El Paso entered into with Mr. and Mrs. Morris Mizel on May 15, 1954. A paragraph found in Article VI, Section 3 of the agreement reads as follows:

> In the event the operation of any well now or hereafter drilled by El Paso shall become unprofitable, then El Paso shall have the option upon sixty (60) days' notice to Mizel to reassign to Mizel such well and the unit upon which such well is situated, and in such event Mizel shall have the option to sell gas produced therefrom to El Paso at the highest price paid for gas of like kind and quality in the field by El Paso or any other bona fide pipeline company, and El Paso agrees to purchase such gas at such price.[71]

GLA 106, it should be noted, involved a relatively small parcel. A more complex reconveyance clause appears in agreements for more substantial blocks of acreage, such as GLA 78 with both Three States Natural Gas Company and Albuquerque Associated Oil Company. In that agreement, which conveyed drilling rights to both Pictured Cliffs and Mesaverde horizons underlying more than 15 square miles, the clause[72]

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[70] The clause tended to appear in the earlier contracts. It is found in the seminal GLA 47, in GLAs 52, 60, and 61, respectively in the second, third, and fourth of the GLAs signed, and in GLAs 76, 77, 78, and 106.

[71] Exh. 30, p. 8.

[72] Part of Article VI, Section 2 of Exh. 29 at pp. 14-15.

read as follows (the interest owners are designated as FIRST PARTIES with El Paso as SECOND PARTY):

> In the event that development hereafter in the area of or adjacent to any drilling units should evidence that such drilling unit will not be productive of gas in commercial quantities in the formation applicable to such drilling unit as above specified and for such reason SECOND PARTY shall not desire to drill such well thereon, then SECOND PARTY shall promptly reassign any such drilling unit to FIRST PARTIES or to any person whom FIRST PARTIES may designate and thereupon shall be relieved of its obligation to drill a test well thereon to the formation applicable; provided that SECOND PARTY may retain any commercial gas well completed therein in a shallower or deeper formation, together with its rights in such drilling unit down through such shallower or deeper formation. In the event the operation of any well now or hereafter drilled shall become unprofitable, then SECOND PARTY shall have the option upon sixty (60) days' notice to FIRST PARTIES to reassign to FIRST PARTIES such well and the unit upon which such well is situated, and in such event FIRST PARTIES shall have the option to sell gas produced therefrom to SECOND PARTY at the highest price paid for gas of like kind and quality in the field by SECOND PARTY or any other bona fide pipeline company, and SECOND PARTY agrees to purchase such gas at such price.

All of the GLA agreements featured a favored nations clause. The standard clause, which is virtually identical in all of the contracts, obligated El Paso to pay the interest owner any higher price it might subsequently pay under a lease-sale agreement involving lands within a 200-mile radius of the acreage. Since the Basin, at its widest point, was considerably less than 200 miles across, the provision for payment of the highest price that El Paso negotiated for lease-sales within a radius of 200 miles assured each interest owner that he would be treated on a par with all other sellers of leases in the San Juan Basin. In this context, it should be noted that at that time El Paso was the only pipeline making lease-sale contracts and the only one that seemed likely ever to do so.

VII

El Paso was not to be alone for long, however.

As the United States entered the 1950's, the Pacific Northwest area of the country remained as the last major untapped market of the natural gas industry. On June 28, 1950, PNW asked the Federal Power Commission for authority to serve that region and local distributors in its major metropolitan areas, Seattle, Washington and Portland, Oregon with natural gas. The application contemplated the construction and operation of a long-distance pipeline commencing in Wharton County, Texas and rooted in the gas fields of the Texas Gulf Coast.

By the Spring of 1952, however, PNW's focus had shifted from the Texas Gulf Coast as its gas-supply source to the San Juan Basin, an area more than a thousand miles closer to the potential market. On August 27, 1952, PNW amended its application for a certificate of public convenience and necessity to specify that the proposed pipeline would be anchored in the San Juan Basin.[73]

A major task for PNW was to secure dedication of reserves to its proposed system. To do so, PNW sought commitments from independent producers who owned substantial reserves in the San Juan Basin. PNW offered a number of the producers the option of either a conventional wellhead sale of natural gas or, alternatively, a sale of the gas reserves in place, with the producers reserving an overriding royalty that would vary with the quantity of gas produced. Under the "wellhead sale" option, PNW originally offered to pay ten cents per Mcf for the first five years, with an escalation of one cent per Mcf every five years thereafter. Under the "in-place" option, PNW offered an initial price of five and one-half cents per Mcf and

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[73] The full scope of the proposal was massive, calling for the construction of an entirely new pipeline system consisting of 1,184 miles of main line and approximately 150 miles of lateral lines. The plans contemplated that, by the third year of operation, the PNW pipeline would carry its maximum design capacity: 314,000 Mcf of gas per day.

periodic escalations thereafter, with the producer having the option to price the gas at its fair market after the twelfth year. Subsequently, PNW raised its offering price under both options; it offered 12 cents per Mcf as the initial price for a wellhead sale and approximately seven cents per Mcf as the initial price for a gas-in-place sale. The complainants say that the five-cent-per-Mcf difference between the two options reflected the costs that would be incurred by one who performed the functions that fell to the operator of a gas lease, *e.g.*, drilling, operation, and payment of production taxes.[74] There is some indication that contemporaneous computations by persons knowledgeable in the business of extracting gas from San Juan Basin reservoirs calculated those costs at about 4.5 cents per Mcf. However, nothing in the record tells us convincingly whether the close approximation of those two figures was the result of design or happenstance.

PNW's first success on the road towards obtaining the reserve commitments it needed was achieved on June 12, 1952. On that date, PNW entered into a "commitment" agreement with Phillips Petroleum Company. Under the agreement, Phillips conditionally dedicated acreage in the Basin to PNW. Phillips retained the option of selecting either a conventional wellhead sale or a sale of gas in place as the ultimate form of the transaction. Phillips exercised its option on January 9, 1953, when it formally executed a lease-sale agreement with PNW, thereby choosing the in-place-sale option. The lease-sale agreement, which was eventually denominated PLA 5, covered approximately 202,000 acres located generally in the northern and eastern portion of the Basin. Under the agreement, PNW acquired rights in the Phillips leases down to, and including, the Mesaverde formation.

The lease-sale agreement contemplated the transfer to PNW of 3 Tcf of recoverable gas reserves. PNW was obligated, after a period of time, to reassign to Phillips acreage

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[74] See CPFF Nos. 476-77, p. 118.

underlaid by any reserves in excess of the 3 Tcf figure. Phillips reserved an "overriding royalty" on all gas produced by PNW from the PLA 5 acreage. During the first year after gas from the PNW pipeline was first sold for resale, the royalty payment was to be seven cents per Mcf. After that first year, the price was to be eight cents per Mcf for the next nine years. During the succeeding year, the eleventh after the pipeline first began operation, the price was to be nine cents per Mcf. Then, the price was to rise to ten cents per Mcf, where it would remain until 20 years had elapsed from the opening of the PNW line. After expiration of those first 20 years, the price was to be redetermined under a formula: the redetermined price would be 75% of the average of the three highest wellhead prices being paid by any pipeline in the Basin for high-volume (20,000 Mcf/d or more) deliveries. In no event, however, could the redetermined price be less than eleven cents per Mcf for the first five years, plus one cent per Mcf for each five years thereafter.

Under the agreement, Phillips reserved all rights to oil and casinghead gas in the formations transferred to PNW and all rights to any hydrocarbons found below those formations.[75] PNW agreed to reimburse Phillips at the closing for Phillips' costs of drilling and completing every well on the acreage as of the closing, if the well met minimum standards of production.[76] PNW was obligated to develop the acreage in such a manner that there would be at least 250 net wells completed on the acreage by July 1, 1955.[77] PNW was given the right to reassign

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[75] That is, below the base of the Mesaverde.

[76] The standards specified that a well would have to produce at least 750 Mcf/d against atmospheric pressure after a three-hour flow to be eligible. At the time the agreement was made, the estimated cost of drilling such a well into the Mesaverde formation was $90,000.

[77] When acreage is communitized, the production of a well drilled on that acreage is shared by all working interest owners in proportion to their contributions to the communitized acreage. See Tr. 305-06. Hence, if Phillips' rights applied to one-half of a proration unit, a well

to Phillips any acreage which it decided would be unprofitable or uneconomical to develop, thereby relieving itself of all obligations to develop that acreage.

The contract required PNW to acquire from the San Juan Basin (either by purchase, production, or both) all of its daily gas requirements up to 350 MMcf per day, except for 20 MMcf per day, which could be secured from other places. PNW could fulfill this requirement with gas from the Phillips acreage or from elsewhere in the Basin. The 350-MMcf/d figure gave PNW very little leeway to look to sources other than those in the Basin, in light of the fact that the initial design capacity of its pipeline was to be 314 MMcf/d.[78]

Since the contract was executed at a time when the pipeline did not exist as such, it is not surprising to find that the parties made the contract's viability contingent upon two events: First, PNW would have to obtain the requisite certificate of public convenience and necessity from the Federal Power Commission. Second, PNW would have to obtain a satisfactory certificate of financing from a reputable financial institution.

At about this time, other independent producers in the San Juan Basin were recipients of similar offers from PNW. On July 21, 1952, PNW made its option proposal to the Stanolind Oil and Gas Company, which owned substantial reserves of natural gas in the Basin. At first, Stanolind refused to commit any acreage to PNW under either branch of the option scheme. Subsequently, however, Stanolind entered into three "commitment" agreements, dated March 13, 1953, March 10, 1954, and February 1, 1955, with PNW. Under these agreements, Stanolind conditionally assigned over 146,000 acres to PNW.[79]

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drilled on the unit would constitute one gross well but only one-half of a net well. Two such wells would add up to one net well. Consequently, meeting an obligation to have 250 net wells on the PLA 5 acreage by July 1, 1955 might well entail drilling many more wells than that.

[78] See n. 73, *supra*.

[79] The March 13, 1953 agreement, together with an agreement dated eleven days earlier, conditionally assigned acreage in which

These "commitment" agreements, like the original Phillips "commitment" agreement, were not lease-sale agreements. Their purpose was simply to secure sufficient promise of an adequate supply of natural gas to demonstrate the viability of PNW's pipeline project to both the FPC (in the pending certificate proceeding) and the financial community (which would be asked to some up with the capital to construct the project). Lease-sale agreements were, in fact, executed with Stanolind in March of 1955.

On July 13, 1953, Sinclair Oil and Gas Corporation and PNW entered into PLA 2, a lease-sale agreement covering some 3,600 acres located in the northwest corner of the San Juan Basin. The agreement contained essentially the same provisions as were found in the Phillips agreement (PLA 5), with only minor variation.[80] The contract did not contain either a take-or-pay clause or a favored nations clause.

The next "commitment" agreement was between PNW and Skelly Oil Company. It was entered into on July 29, 1953 and covered approximately 19,000 acres scattered throughout the San Juan Basin.[81] The text of the "commitment" agreement noted that PNW had entered into a lease-sale with Phillips and simply incorporated the terms of the Phillips lease-sale con-

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both Stanolind and Colorado Oil and Gas Company held interests. CPFF No. 490, p. 122.

[80] For example, PLA 2 required PNW to drill at least ten net wells on the acreage by July 1, 1955, whereas PLA 5 called for PNW to have 250 net wells by that date on the acreage transferred by Phillips. See Exh. 47, "Contract," p. 8. Unlike the Phillips contract, PLA 2 did not recite the parties' intention to assign a specific volume of gas to PNW. The overriding royalty and redetermination provisions of the two contracts were, however, markedly similar. As was the case in the earlier PLA, the contract with Sinclair was conditioned upon PNW obtaining an FPC certificate to build and operate the pipeline.

[81] The Skelly acreage was the subject of PLA 3 and is colored purple on the map that is Exh. 95.

tract (PLA 5) by reference. In addition to the terms that Phillips secured, Skelly demanded, and eventually received, a favored nations clause, and a ratable-take clause to assure that its acreage would be developed at the same rate as other San Juan Basin acreage under contract to PNW. As was the case with the earlier agreements, the Skelly "commitment" was conditioned upon issuance of an FPC certificate to PNW.[82]

On August 5, 1953, the Chicago Corporation (Chicago) and PNW signed a lease-sale agreement. The agreement, PLA 14, covered approximately 3,800 acres located generally in the eastern portion of the Basin.[83] PLA 14 was similar in nature to PLA 2, the Sinclair lease-sale agreement, that had been executed less than a month previously. PLA 14 did not have either a take-or-pay clause or a favored nations clause. In this respect, too, it was like the Sinclair contract. Its pricing provisions were similar to those that would ultimately be incorporated into the Phillips agreements: a two-tiered pricing system, in which Mesaverde gas was priced in accordance with the well's deliverability rate, while gas from other formations was priced in the more conventional manner.[84] In all other major respects, however, PLA 14 was substantially identical to the Sinclair (PLA 2) and Skelly (PLA 3) agreements.

The commitment of gas reserves to PNW under the agreements discussed above was apparently sufficient to carry the day for PNW in the Federal Power Commission's proceedings. The Commission had consolidated PNW's application with other competing applications for authority to serve the Pacific

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[82] See Exh. 48.

[83] PNW had sent Chicago an option proposal by letter dated January 9, 1953. Chicago accepted the proposal, thereby entering into a "commitment" agreement, four days later. See Exh. 72; Tr. 261-62.

[84] The Phillips agreement was, in fact, amended to include a variable-price structure for Mesaverde gas. The amendment took place on August 4, 1953, only four days after the execution of PLA 14 with Chicago.

Northwest and had conducted a comparative hearing. One of the issues, which the Commission resolved favorably to PNW, was whether there were sufficient reserves of natural gas dedicated to the proposed service.[55] In Opinion No. 271, issued on June 18, 1954, the Federal Power Commission granted to PNW the certificate of public convenience and necessity that it had sought.[56]

Only two more "commitment" agreements were signed after the Commission's action. The last of them, the February 1, 1955 agreement between PNW and Stanolind, has been discussed above. The other was an agreement, executed January 25, 1955, between T. H. McElvain and PNW, which committed gas reserves down to the base of the Mesaverde formation underlying some 1,500 scattered acres in the San Juan Basin.[57] From our standpoint, the most significant feature of the McElvain commitment agreement (which eventually matured into PLA 4) is that it specifically incorporated by reference the provisions of the Phillips lease-sale agreement—PLA 5—with only minor variations.

On February 11, 1955, the Federal Power Commission approved PNW's plan of financing for its proposed pipeline. This step rendered PNW's certificate final and permitted PNW to close many of the conditional commitment and lease-sale agreements into which it had previously entered:

—On February 22, 1955, PLA 14 between PNW and Chicago was closed. Leasehold interests in approximately 3,800 acres were conveyed to PNW. There were no wells on the acreage at the time of the closing. The present interest owner under PLA 14 is Champlin Petroleum Company.

—PLA 5, between Phillips and PNW, was closed one day later, on February 23, 1955. Approximately 188,700 acres were assigned. There were 75 wells, for which PNW paid

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[55] *Northwest Natural Gas Co.*, 13 FPC 221 (1954).

[56] *Id.* at 238-39.

[57] See Exh. 95, on which the McElvain acreage is colored yellow.

approximately $5,600,000, on the acreage at the time of the closing.[88] Phillips remains the interest owner under PLA 5 today.

—Skelly and PNW closed on PLA 3 on March 3, 1955. At the time of closing, there were seven wells on the acreage, and PNW paid a total of $452,270 for those wells. The present interest owner under PLA 3 is Getty Oil Company.

—On March 8, 1955, Sinclair and PNW closed on PLA 2, which transferred Sinclair's rights to about 3,600 acres. PNW paid $46,615 for the one well that was on the acreage at the time of the closing. Atlantic Richfield is the present owner.

—Eight separate lease-sale agreements between Stanolind and PNW were both executed and closed on March 16, 1955. The agreements covered a total of approximately 146,000 acres in the San Juan Basin. The eight separate tracts were widely scattered around the rim of the Basin. Six of the lease-sale agreements, covering approximately 116,150 acres, are PLAs 6-11, which are involved in this proceeding. The other two were aborted when PNW reassigned the acreage covered by the agreements to Stanolind in accordance with its contractual right to give back any acreage judged unprofitable or uneconomical to develop.[89] The texts of PLAs 6-11 were all essentially similar, although there were some minor variations. At the time of the closing, there were 40 wells on the acreage. PNW paid approximately $1,400,000 for the wells. The present interest owner under PLAs 6-11 is Amoco Production Company.

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[88] The record does not contain a breakdown of the wells on this, or any other, PLA acreage as between Mesaverde wells, Pictured Cliffs wells, or wells in any other formation.

[89] The PLA contracts covered acreage in the Bondad area (PLA 6), the Huerfano area (PLA 7), the Ignacio area (PLA 8), the Northwest Cedar Hill area (PLA 9), the Rosa unit (PLA 10), and the Township units (PLA 11). The areas covered by the two agreements which were reassigned were the Arboles and the North Rosa areas. They are not at issue in this case.

—PLA 4, between PNW and T. H. McElvain, was closed on September 1, 1955. On that date, there was one well on the 1,500 acres transferred to PNW. McElvain, *et al.* are the interest owners under PLA 4 today.

The last of the PLA agreements was PLA 13, executed and closed on April 23, 1957, some 20 months after the rest of the PLA agreements. Under PLA 13, General Petroleum Corporation transferred to PNW leasehold interests in some 13,000 acres located in La Plata County, Colorado, in the northern portion of the San Juan Basin. The agreement was similar in nature to the Stanolind agreements (PLAs 6-11) with only minor variations.[90] On April 23, 1957, the date of closing, there were two wells on the acreage subsumed by PLA 13. As of that date, gas from the PLA 13 acreage had been flowing in interstate commerce via the PNW pipeline for seven months.

The last step needed to permit PNW to build the pipeline had been taken in New York City a little less than two years before PLA 13 was closed. On May 4, 1955, the financing agreements were closed. Under those agreements, PNW issued $93,200,000 in First Mortgage Pipeline Bonds; in addition, it sold bank notes, interim notes, and common stock. With the money in hand, PNW was able to construct the pipeline rapidly. It was finished the following year, and on September 1, 1956, natural gas began to flow through it from the San Juan Basin to consumers in Seattle and Portland.

El Paso's purchase of PNW, which took place in 1957, and the merger of the two companies in 1959 touched off more than a decade of antitrust litigation.[91] As a result of the lawsuits, El

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[90] For example, PLA 13 imposed on PNW development obligations which were somewhat less stringent than those in the Stanolind agreements. Another provision of PLA 13 gave General Petroleum the right to require PNW either to drill in any location General Petroleum might specify or reassign it to General Petroleum. The Stanolind agreements contained no comparable provision.

[91] Citations to the litany of cases arising out of the Government's suit to compel El Paso to divest itself of the former PNW assets are set forth at n. 10, *supra*.

Paso was compelled to divest itself of the assets once held by PNW which, after the merger, had become the Northwest Division of El Paso. The Northwest Division was acquired by Northwest Pipeline Corporation on February 1, 1974. Included among the assets purchased by Northwest in the transaction were all of the PLA agreements.

In most important respects, the terms of the PLA lease-sale agreements were similar:

Pricing. There was a basic scheme of compensating the interest owner, which recurred with few exceptions. All of the contracts called for PNW to pay the interest owner an overriding royalty, calculated as a specified sum for each Mcf of gas produced from the acreage, beginning on a specified date.[92] The initial price was 7 cents per Mcf, except for Mesaverde gas produced under PLAs 4, 5, and 14. The first increment of Mesaverde gas under those three contracts was priced at 6 cents per Mcf, but that base rate could be higher, depending on the rate at which the well produced. The contracts all provided for periodic escalations of the base rate at specified intervals for the first 20 years (in the case of PLAs 2, 3, 4, 5, and 14) or for the first 25 years (in the case of PLAs 6-11 and 13). These escalator clauses called for increasing the payment by one cent per Mcf through the end of the tenth year, another cent per Mcf for the eleventh year, another cent per Mcf during years 12 through 20, and, in the case of PLAs 6-11 and 13, one more cent per Mcf in the twenty-first through the twenty-fifth years. After the twentieth year (or the twenty-fifth year under PLAs 6-11 and 13), the interest owner had the option of receiving either a continuation of the periodic one-cent-per-Mcf escalations—with the interval between escalation dates being set at five years—or being compensated under an "arithmetic average" formula. It is not necessary to go into all the complex-

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[92] In all of the contracts except PLAs 2 and 13, the date fixed for the payments to begin was the date of the first sale of gas for resale from PNW's pipeline. As it turned out, that date was September 1, 1956.

ities of the formula; its purpose was to entitle the interest owner to receive an amount equal to 75% of the average price being paid for gas sold at the wellhead in the area, if, by doing so, he would be paid more than the amount he would otherwise receive during any of the quinquennial, one-cent-per-Mcf, escalation periods. As an added feature, the interest owners under PLAs 6-11 and 13 were entitled to a *third* payment option: Commencing after the close of the tenth year, they could elect to receive an amount equal to five cents less than the average of the prices being paid for wellhead sales at the time the option was exercised.[93] Only one of the contracts, PLA 3, contained a favored nations clause. Given the multiplicity of payment options, each tending to ensure parity of treatment for the interest owner, it is not surprising that this ubiquitous provision was omitted for the most part.

Horizons and Hydrocarbons Conveyed. With the exception of PLAs 6, 7, and 8, all of the PLA agreements conveyed the gas rights in all formations from the surface down to the base of the Mesaverde. PLA 6 gave PNW rights to gas from the surface down to the base of the Morrison formation, which is below the Mesaverde. PLA 7 conveyed only rights to gas found from the surface to the base of the Pictured Cliffs formation. PLA 8 transferred gas rights in the Mesaverde and Morrison formations only; it did not give PNW any rights to Pictured Cliffs gas. In every case, the interest owners reserved all rights to oil, regardless of where it might be found.

Development and Minimum-Take Provisions. The PLA contracts contained a variety of provisions designed to assure that the acreage transferred would be fully and promptly developed. There were, first of all, conventional take-or-pay clauses, requiring PNW to take from the acreage, or pay for, a

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[93] PLA 13 provided that the wellhead prices used to compute entitlement under the formula had to be prices paid within a specified radius of the delivery point of the PLA-13 gas. PLAs 6-11 contained no such limitation.

specified minimum volume of gas. Of course, the only way PNW could acquire that minimum volume of gas was to produce it from the acreage transferred. Such a clause is found in PLA 13 and PLAs 6-11. PLA 3 had a so-called "ratable take" clause, which obligated PNW to take its natural gas supply from the PLA 3 acreage ratably with gas taken from other acreage under contract to the pipeline company. PLAs 4 and 5 contained a clause which required PNW to acquire almost all of its natural gas requirements up to 350 MMcf per day from the San Juan Basin.[94] In addition, most of the agreements imposed very specific developmental obligations upon PNW. In time, wells were to be drilled upon all available drilling locations;[95] otherwise, the acreage was to be reassigned. PLA 2, which had no take-or-pay clause or similar provision, required PNW to drill at least ten wells after the closing and to reimburse Sinclair, the interest owner, for wells which Sinclair had drilled before the closing.[96] PLA 5, which assigned the largest tract, required PNW to have at least 250 net wells on that acreage by a specified date. It also provided that the interest owner, Phillips, would be reimbursed for wells that it had drilled before the closing.[97] The Stanolind agreements (PLAs 6-11) provided for ratable development of the acreage with a minimum of 25% of it fully developed within two years, 75% of it developed within four years, and all of the acreage completely developed within seven years. PNW was also required to

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[94] See p. 48, *supra* for additional description of the contents of this clause.

[95] As we have noted above, *supra at mimeo* p. 35, the drilling of the wells was subject to spacing restrictions imposed by state law. There could be no more than one Mesaverde well on each 320-acre drilling location and no more than one Pictured Cliffs well on each 160-acre location.

[96] As it turned out, there was only one well on the PLA 2 acreage at the time of closing. See Exh. 96.

[97] There were 75 gross wells (54.3 net wells) on the PLA 5 acreage when the closing took place. They cost PNW about $5 million.

reimburse Stanolind for wells that Stanolind had drilled on the acreage before closing.[98] The development obligations of PNW under PLA 13 were somewhat less detailed. PNW was required to drill on each of two of the five different lease blocks during the first year after the closing. By December 31, 1958, there were to be at least seven wells (including those drilled before closing) on the acreage, at least one of which had to be located on each of the five Indian leases assigned under the agreement. After the third year, "orderly development" of the acreage was mandatory. However, General Petroleum was given the right to require PNW to drill at any specified well location or to reassign it.

Reassignment. All of the agreements permitted PNW to reassign to the interest owner any acreage PNW considered noncommercial In some of the agreements, PNW's discretion to exercise its reassignment rights was limited by the requirement that it must act in good faith. As we have noted,[99] PNW exercised its reassignment rights in connection with two of the parcels, both of which were reassigned to Stanolind in 1958.

VIII

As we have seen,[100] the initial lease-sale agreements were made at a time when the apotheosis of the governing law consisted of the holding in *Panhandle*[101] that the "production or gathering" exemption of § 1(b) of the Natural Gas Act[102] prohibited the FPC from assuming jurisdiction to regulate the transfer of gas leases. Looming on the horizon at that time was the *Phillips* case, in which the Commission was tentatively and

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[98] There were 40 such wells (18.021 net wells) that cost PNW $1.4 million.

[99] *Supra* at mimeo p. 53.

[100] *Supra*, n. 38.

[101] *F.P.C.* v. *Panhandle Eastern Pipe Line Co.*, 337 U.S. 498 (1949).

[102] 15 U.S.C. 717(b).

reluctantly dipping its toe into the dispute about the jurisdictional status of wellhead sales by independent producers.[103]

The finale of the *Phillips* case was written in 1954, just as the use of lease-sale agreements in the San Juan Basin was becoming institutionalized. In *Phillips Petroleum Co. v. Wisconsin*,[104] the Supreme Court held that a wellhead sale of natural gas by an independent producer to an interstate pipeline was a sale of natural gas for resale subject to regulation by the Federal Power Commission. Such a sale did not fall within the "production or gathering" exemption, the Court held; that exemption was applicable only to the "physical activities, facilities, and properties used in the production and gathering of natural gas."[105]

The *Phillips* decision lent added impetus to the use of lease-sale agreements as a means of transferring natural gas from independent producers to pipelines. The industry and its lawyers apparently reasoned that although *Phillips* would render a transfer via a conventional wellhead sale jurisdictional, the same transfer could be achieved without invoking the Commission's jurisdiction by structuring the transaction as a lease-sale of "gas in place" to the interstate pipeline, with the independent producer retaining an "overriding royalty," with or without a "production payment." This was thought to be the result required by the *Panhandle* holding, the integrity of which was considered unmarred by *Phillips*.

In retrospect, it is clear that such unalloyed faith in *Panhandle* was misplaced—for *Phillips* had severely undercut the notion, one of the chief premises of the *Panhandle* holding, that anything done before the gas was injected into the interstate pipeline fell outside FPC jurisdiction under the "production or gathering" exemption. In *Phillips*, as we have seen,

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[103] See *Phillips Petroleum Co.*, 7 FPC 983 (1948).

[104] 347 U.S. 672 (1954).

[105] *Id.* at 678.

the scope of the exemption was limited to the "physical activities, facilities, and properties used in the production and gathering of natural gas."[106]

No such doubts assailed the industry in the 1950's, however. During that decade, a large number of gas sale transactions, both in the San Juan Basin and elsewhere, were cast or recast in the format of lease-sale contracts or other arrangements for the sale of gas in place.

It was a comfortable world. A clear, simple, unvarying rule of law that permitted any knowledgeable lawyer with a modicum of ingenuity to place his client under, or remove him from, FPC jurisdiction as the client might wish. It lasted for about ten years. Then the *Rayne Field* case was decided.

In the *Rayne Field* case, the Supreme Court abandoned the *Panhandle* Court's fundamental hypothesis that "leases are an essential part of production"[107] and rejected the conclusion that transfers of leases *per se* were exempt from the FPC's regulatory jurisdiction.[108] Justice Harlan, delivering the opinion of the Court, said that although a transaction is cast in the form of a sale of a leasehold interest, it may still be jurisdictional if it amounts to the "economic equivalent" of a sale of natural gas subject to regulation under the Natural Gas Act.[109]

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[106] *Id.*

[107] 337 U.S. at 505.

[108] *United Gas Improvement Co. v. Continental Oil Co., supra,* 381 U.S. at 404. The Court did acknowledge that "some" lease transfers may be exempt transactions, referring to the facts of *Panhandle*, wherein leases covering *an undeveloped field* were transferred *by an interstate pipeline to a producer*, not *vice versa*. The Court thus limited the *Panhandle* holding stringently to its facts, rather than overruling *Panhandle* outright. To those who saw in the lease-sale format a perpetual exemption from unwanted Federal regulatory jurisdiction, however, *Rayne Field* was a severe blow.

[109] 381 U.S. at 400. The Court also held that the manner in which state law characterizes the transaction is irrelevant to the question of

Under the *Rayne Field* case's "economic equivalent" doctrine, a lease-sale agreement would clearly be subject to regulation as a jurisdictional sale of gas at the wellhead if it is held to be economically equivalent in substance to the conventional wellhead sale which the Court held to be jurisdictional in *Phillips*. The *Rayne Field* Court did not, however, define "economic equivalency" with precision. Nevertheless, certain controlling principles do emerge from the Court's discussion, and other elements of the doctrine may be discerned from the factual setting which was before the Supreme Court.

In *Rayne*, an interstate pipeline had made an arrangement to purchase natural gas from a consortium of producers at a specified unit price. The gas was to be produced from leaseholds in Rayne Field, Louisiana. Both the pipeline and the producers applied for the FPC certificates needed to carry out the deal—the producers sought authority to make the sale, and the pipeline applied for authority to build the facilities to connect its system to the field. Before the Commission acted, however, the parties cancelled the sales contract and "then agreed on a different method for achieving their objectives."[110] The parties agreed to cancel the wellhead sales contract and to substitute for it a lease-sale contract, under which the pipeline would purchase the producers' leasehold interests in the field. The pipeline agreed to make a lump-sum payment for the

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its jurisdicational status under the Act: "A regulatory statute such as the Natural Gas Act would be hamstrung if it were tied down to technical concepts of local law." *Id.*

[110] 381 U.S. at 396. The problem, so far as the producers were concerned, was the decision in the *Catco* case, *Public Service Comm'n* v. *F.P.C.*, 257 F.2d 717 (3rd Cir. 1958), *aff'd sub nom. Atlantic Ref. Co.* v. *Public Service Comm'n*, 360 U.S. 378 (1959), which upheld the Commission's right to condition certification of new wellhead sales upon the parties' acceptance of a lower price than the one for which they had contracted. The price in the *Rayne Field* contract was 1.5 cents per Mcf higher than the price in the *Catco* contract.

leasehold interests, but the payment took the form of notes which were payable over a 16-year period. The pipeline set up a subsidiary to enter into the formal purchase contract, thereby shielding itself from liability if the field's gas production proved to be smaller than anticipated. The pipeline also made a management contract under which one of the producers would perform most of the actual production work. The pipeline had substantial authority to make decisions about development of the field: it was empowered to determine whether new wells should be drilled and the volumes of gas to be nominated each month for production. Additionally, the Court found that "The gas reserves in Rayne Field were proven, and the field was substantially developed."[111]

After first regarding the lease-sale as nonjurisdictional, the Federal Power Commission had taken the position that the transaction fell within the scope of its regulatory powers under the Natural Gas Act. However, the Commission had refused to issue a certificate to permit consummation of the lease-sale, because the form of the transaction made it impossible to ascertain whether the price the pipeline would ultimately pay for the Rayne Field gas was in the public interest. The U.S. Court of Appeals for the Fifth Circuit had reversed the Commission's determination, holding that *Panhandle* placed the sale of leaseholds outside the FPC's regulatory jurisdiction.[112]

In reversing the Court of Appeals and holding that the lease-sale agreements were jurisdictional, the Supreme Court said:

> it is perfectly clear that the sales of these leases in * * * a proven and substantially developed field, accomplished the transfer of large amounts of natural gas to an in-

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[111] 381 U.S. at 396 (footnote omitted). There were 19 wells in being and 7 more yet to be drilled at the time the contract was closed.

[112] *Marr* v. *F.P.C.*, 336 F.2d 320 (5th Cir. 1964).

terstate pipeline company for resale in other States. *That is the significant and determinative economic fact.*[113]

The Court also emphasized that "to ignore [the economic equivalency of the lease-sale to a conventional wellhead sale] would substantially undercut *Phillips*. * * * "[114]

In *Rayne Field*, therefore, the Supreme Court established a functional approach to the problem of determining whether a transaction between an independent producer and an interstate pipeline amounts, in law, to a jurisdictional sale for resale of natural gas. What is important, under the Court's holding, is not the form of the transaction but whether it accomplishes substantially what a wellhead sale is intended to accomplish: the transfer of known, available reserves of natural gas to the pipeline.

In reaching that result, the Court in *Rayne* criticized its earlier *Panhandle* opinion, which had placed great reliance on the form of the transaction and had dismissed the difficult question of construing the substance of the transaction with the airy observation: "Of course leases are an essential part of production."[115] Such "flat statements," said the Court in *Rayne*, "should not be taken to cover more than the particular kind of leases that were before the Court [in *Panhandle*]; it should not be considered as embracing each and every transfer that can be put in lease form."[116] Hence, *Panhandle's* holding was limited strictly to its facts—the transfer by an interstate pipeline of leases covering an undeveloped field to a production company for ultimate sale and consumption of the gas in *intrastate* commerce.

In spite of the clarity with which the *Rayne* Court resolved the immediate issues before it, the Court nevertheless failed to

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[113] 381 U.S. at 401 (emphasis added).

[114] *Id.*

[115] 337 U.S. at 505.

[116] 381 U.S. at 404 (citation omitted).

delineate with any degree of specificity the standards by which economic equivalency, the hallmark of jurisdictional status, is to be determined. Nor did the Court tell us how substantial the development of a field must be before lease-sales may be deemed economically equivalent to jurisdictional sales of natural gas. Later courts were, therefore, compelled to use the factual setting in Rayne as a rough guideline. In *Rayne Field*, the Court pointed to: the fact that the lease-sale agreement was an alternate method of achieving the parties' intention to consummate a sale of natural gas; the pipeline's decisional role under the lease-sale arrangement (it had a major say in the scheduling of production); the existence of acceleration clauses which, in effect, tied the rate of payment to the rate of gas production; the use of an intermediate corporation to shield the pipeline from liability in the event production did not live up to expectations; the limited mineral rights conveyed by the lease-sale agreement (only natural gas and condensate were conveyed; the producers retained all oil rights); and the substantiality of development and proven condition of the field.

Bastian Bay[117] was a two-sentence, *per-curiam* opinion issued only six days after the *Rayne* decision. In the *Bastian Bay* case, the Supreme Court summarily reversed a Tenth Circuit decision which had held a substantially similar lease-sale agreement non-jurisdictional. Under the agreement, a producer conveyed its leasehold interests in a gas-producing field to an interstate pipeline. The $159 million in consideration was to be paid by means of a cash down payment at the time of execution of the agreement and the balance in notes, payable over a 17-year period. The price was based upon an estimate of reserves, but the agreement provided for redetermination of reserves and a consequent adjustment in the purchase price so as to keep the price per Mcf constant. The field was substantially developed at the time the contract was executed. The pipeline agreed to perform additional development and production

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[117] *F.P.C.* v. *Pan American Petroleum Corp.*, 381 U.S. 762 (1965).

work. In addition, the producer retained the rights to minerals other than natural gas.

It is thus apparent that many of the factors deemed determinative in *Rayne* were also present in *Bastian Bay*. A functional analysis of the lease-sale agreement in *Bastian Bay* leads to the same conclusion reached in *Rayne Field*; that is the reason for the Court's summary reversal, citing *Rayne*. It is equally clear, however, that certain factors present in *Rayne* are not of great weight since they did not exist in *Bastian Bay*. For instance, the Court of Appeals' opinion in *Bastian Bay* does not disclose the existence of any acceleration clauses which geared the payments to production. Nor was the *Bastian Bay* agreement specifically drafted as an alternate method of achieving the same objective as a preexisting wellhead sale contract, as was the case in *Rayne*.

In the *Ship Shoal* case, *Continental Oil Co.* v. *F.P.C.*,[118] the Fifth Circuit found a lease-sale agreement similar to those in the two earlier cases to be jurisdictional. In the process, the Court elaborated upon the functional approach laid down by the Supreme Court in *Rayne*. The Court of Appeals discerned a "three-pronged" test emerging from *Rayne*:

> (1) Is the economic effect of the transfer similar to that of a conventional [wellhead] sale? (2) Is the subject of the transaction "proven and substantially developed" reserves? (3) Is the transfer of the reserves for the purpose of interstate transmission and resale?[119]

The Court of Appeals noted that the *Rayne* test does not require an absolute identity between the lease-sale agreement and a conventional "wellhead" sale; some deviation is permitted. The "fundamental inquiry" is whether the transaction accomplished the transfer of sizeable amounts of natural gas from proven and substantially developed reserves to an in-

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[118] 370 F.2d 57 (5th Cir. 1966), *cert. denied*, 388 U.S. 910 (1967).

[119] *Id.* at 62.

terstate pipeline for ultimate resale in interstate commerce.[120] The answer to this inquiry must, of necessity, be based upon a case-by-case analysis, in which the various relevant provisions contained in the leases, as well as the surrounding circumstances, are scrutinized to determine their economic effect.

The *Ship Shoal* case arose out of a factual setting remarkably similar to that of *Rayne* and *Bastian Bay*. The *Ship Shoal* producers developed offshore leasehold properties which they subsequently conveyed to an interstate pipeline for a lump-sum consideration, with the payments spread over 15½ years.[121] The parties had estimated the volume of recoverable reserves and had provided for a later redetermination of the reserve estimate and a concurrent adjustment of the purchase price to maintain the per-Mcf cost of the gas. While the transfer of leasehold interest purported to convey all mineral rights,[122] the pipeline, nevertheless, had the right to require the producers to purchase all crude oil production at a specified price.[123] The pipeline was to operate and manage the leasehold interests transferred.

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[120] *Id.*

[121] The pipeline agreed to pay over $97 million in cash, with a portion of the consideration to be paid at the execution of the lease-sale agreement. The bulk of the principal obligation was assumed by two subsidiary corporations, but a portion of that obligation was assumed by the interstrate pipeline company itself. The notes contained acceleration clauses, similar to those in *Rayne*, in which the payments were geared to production, "apparently as a security device." *Id.* at 63.

[122] The agreement transferred to the pipeline company the right to extract and sell the oil, casinghead gas, natural gas, condensate, and other natural gas liquids.

[123] The Court held that the producers' obligation to repurchase the oil produced was clearly "a signficant retained interest in Ship Shoal." *Id.* at 63. This option had been almost continuously exercised by the pipeline, which resold to the producers "virtually all oil taken from Ship Shoal." *Id.* The "economic effect" of this provision in the

The Court of Appeals refused to give decisive weight to the fact that the agreement was not a substitute transaction, as was the case in *Rayne Field*. The producers had invited offers from several prospective purchasers structured along the lines of either a lease-sale agreement of a conventional wellhead sale. The objective of the producers, the Court found, was to achieve the highest possible discounted cash flow, and any resulting difference among the various offers for sale or lease "goes more to the method of payment than to the substantial economic effect of the transfer."[124] In addition, the Fifth Circuit viewed the differences between the pipeline's operational and decisional role in the various contracts as "not substantial enough to defeat jurisdiction."[125] The Court thus concluded that the economic effect of the transfer was sufficiently identical to the conventional wellhead sale to satisfy the first part of the three-pronged test it had laid down.

Accordingly, the Court of Appeals determined that the economic effect of the *Ship Shoal* agreement was substantially similar to that of a conventional wellhead sale. The Court also found the level of development sufficient to satisfy the "second prong" of its *Rayne Field* test.[126] The Court reasoned that the basic standard is whether the leasehold interests have been "sufficiently proved and developed for [the] imminent production of natural gas in commercial quantities."[127] According to the Court, the two critical factors for ascertaining whether

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lease-sale agreement was to convey to the pipeline only the mineral rights to natural gas, condensate, and natural gas liquids. This was similar to the lease provisions in *Rayne* and to the "economic effect" of the agreement in *Bastian Bay*. The price to be paid by the producers for this oil was the average price posted in various South Louisiana fields. *Id.* at 60, 63.

[124] *Id.* at 62.

[125] *Id.* at 63.

[126] *Id.* at 63-66.

[127] *Id.* at 63-64. This was essentially the test promulgated by the *Rayne* Court in distinguishing *Panhandle*. Implicit in the distinction

commercial production is imminent are: (1) "definability of gas volume based upon proof of reserves;" and (2) the "imminent ability to produce in commercial quantities."[128]

In *Ship Shoal*, the parties who were appealing from the Commission's determination placed much emphasis upon the fact that only one gas well had been drilled on the acreage covered by the contract. The Court held that the *Rayne Field* doctrine was applicable nevertheless, and that the lease-sale amounted in law to a jurisdictional sale of natural gas for resale. First, the Court of Appeals noted that even though the parties' estimates of the field's reserves varied substantially, ranging from a low of approximately 530,000 MMcf by the pipeline to a high of approximately 823,000 MMcf by one of the producers, the parties were willing to stake considerable sums on a judgment that a very large volume of gas was *there*. The pipeline, the Court pointed out, "was willing to invest over $97 million in its faith in the lowest of the reserve estimates * * *."[129] In addition, the Court reasoned that, notwithstanding the paucity of actual drilling, the reserves were sufficiently proven and definable because—

> a definite and definable volume of gas cannot be determined down to the last cubic foot even after a well has been fully depleted. One can make only estimates of gas. There are some producing areas where it is possible to estimate recoverable reserves with a high degree of accuracy al-

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between undeveloped and substantially developed reserves lies the concept of "imminency of production." As the Supreme Court noted in *Rayne Field*.

> [T]he more that must be done before the gas begins its interstate journey, the less the transaction resembles the conventional wellhead sale of natural gas in interstate commerce which, as *Phillips* held, the Act has affirmatively placed within Commission jurisdiction.

381 U.S. at 403.

[128] 370 F.2d at 64.

[129] *Id.* at 65.

> though the particular leases are undrilled and undeveloped. In offshore fields and in South Louisiana, however, reserve estimates are more difficult to determine even after full development because of multiple formations and faulted reservoirs. The effect of redetermination provision is to negate or diminish substantially the shifting of the risk relating to gas deliverability from [the producers] to [the pipeline].[130]

The Court of Appeals in the *Ship Shoal* case also emphasized the pipeline's readiness to connect the field to its transmission system as a "strong indication that the field was 'substantially developed' at the time of transfer."[131] The Court pointed out that the pipeline had, in fact, included Ship Shoal reserves in papers supporting its applications for FPC certification to expand its facilities. The pipeline did so knowing that the FPC frequently conditioned certification upon actual operation of the facilities within one year. While "It may well be that Ship Shoal is a 'long way' from being fully developed * * * this * * * relates more to determination of final consideration, than to imminent ability for production."[132]

For these reasons, the *Ship Shoal* Court concluded that standards of definable gas reserves coupled with imminent ability to produce had been met sufficiently to satisfy the substantial development test of *Rayne Field*. It held, therefore, that the lease-sale transactions at issue were subject to the Commission's rate-regulation authority. The Court also concluded that a contrary holding would generate "an 'attractive gap' in the regulatory system * * * and the producing states would be unable to close it."[133]

The *Rayne Field-Bastian Bay-Ship Shoal* trilogy represented a major victory for the FPC. It firmly closed the door

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[130] *Id.*

[131] *Id.*

[132] *Id.* at 66.

[133] *Id.* at 67.

upon efforts to use the lease-sale contract as a device to evade the agency's jurisdiction over wellhead sales, including (most importantly) the agency's power to establish ceiling prices for all gas sold to the interstate market. Emboldened by its triumphs and persuaded that the *Panhandle* precedent had been permanently eradicated, the Commission decided to strike out against all lease transactions which contained market-value royalty clauses.[134] The Commission's position was that a lessor who claimed a royalty based upon the market value of the gas extracted from his land had an "economic interest" in the sale of the gas sufficient to invoke the principles established in *Rayne Field* and its progeny. The test case was Opinion No. 562,[135] in which the Commission, by a 3-2 vote, asserted jurisdiction over a group of lessors who had retained a market-value royalty, ruling that they had in fact "contracted to retain an economic interest in interstate sales, [and had] joined the other interest owners [the producers] in such sales, [thereby becoming] a seller of natural gas and therefore a natural gas company."[136]

The Commission's efforts in Opinion No. 562 were turned aside in *Mobil Oil Corp.* v. *F.P.C.*,[137] in which the Court held that the landowners' retention of a market-value royalty interest in a lease transferring natural gas reserves to a producer did not, *ipso facto*, render the landowner-lessor subject to the jurisdiction of the Federal Power Commission. Writing for the Court, Judge Leventhal reasoned that the lessor's economic

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[134] The effect of such a clause, if construed to entitle the lessor to a royalty based upon current intrastate gas prices could easily push the lessee-producer's royalty costs above the FPC-established ceiling price for gas of that vintage. At a mimimum, a market-value royalty would create volcanic pressures for higher prices. *Cf. F.E.R.C.* v. *Pennzoil Producing Co.*, 47 U.S.L.W. 4123 (January 16, 1979).

[135] 42 FPC 164 (1969).

[136] *Id.* at 172.

[137] 463 F.2d 256 (D.C. Cir. 1971), *cert. denied*, 406 U.S. 976 (1972).

interest in the sale of the gas for resale in interstate commerce was insufficient, "standing alone and without any of the other attendant incidents of sale" to make the lease transaction jurisdictional.[138]

In *Mobil*, the gas reserves underlying the leased acreage were not proven, nor was the field substantially developed.[139] Additionally, the lease did not constitute the "economic equivalent" of a wellhead sale under the *Rayne Field* guidelines, the Court said.[140] Instead, the Court held, the lease involved in the case "is a transaction that is itself customary and conventional, one that precedes the 'conventional' sales in interstate commerce with which Congress was concerned * * *."[141] This type of landowner-lease transaction, the Court added, "indeed even precedes the 'production and gathering' which § 1(b) visualized as preceding the sale in interstate commerce over which jurisdiction was being established."[142]

The Court therefore determined that the lease before it was not the "economic equivalent" of a wellhead sale within the meaning of the traditional *Rayne Field* standards. The Court of Appeals went on, however, to resurrect the pre-interstate-movement/post-interstate-movement analysis of the *Panhandle* case, saying:

> the significant fact for a sale in interstate commerce is interstate movement either by the seller, prior to or in connection with the sale, or by the purchaser, typically an

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[138] *Id.* at 262-63.

[139] As the Court pointed out, the typical gas lease "transfers only the right to explore, develop, and market if exploration is successful; no royalty is paid if no gas is discovered." *Id.* at 262. This situation was distinguished from the ones in *Rayne Field*, *Bastian Bay*, and *Ship Shoal*, where the lease-purchaser's downside risk (*i.e.*, no gas or not much gas) was of a much different order of magnitude.

[140] *Id.*

[141] *Id.*

[142] *Id.*

> interstate pipeline company, subsequent to or in connection with the sale. In the case of a typical oil and gas lease, there is no such interstate movement by either the transferor or transferee.[143]

What this method of analysis misses, of course, is that the order of events, *e.g.*, whether interstate movement of gas precedes the execution of the formal documents (call them leases, assignments, or what you will), is commonly within the control of the parties to the transaction and, to the extent the Federal courts will sit still for it, can be rigged to fit within, or fall outside of, the Commission's regulatory jurisdiction in accordance with the parties' wishes. This is precisely the reason why the *Rayne Field* Court held that the order of events does *not* constitute a valid basis for finding a transaction jurisdictional *vel non*. For the author of *Mobil* to revert back to that long-discredited analytical test, even by way of *dictum*, may simply demonstrate that, on occasion, Homer nodded.

There is no question about the correctness of the result, of course, because the critical incidents of a conventional wellhead sale were clearly absent in the *Mobil* case. The landowner-lessors had no knowledge at the time the lease was executed of "the ultimate destination of any gas that might be discovered."[144] They did not know, and had no way of discerning, whether, assuming that gas proved to be present and producible in commercial volumes, the ultimate buyer of the gas would move it in interstate commerce, purchase it for resale, or purchase it for his own use. The lessors retained no control over any of the other incidents of a conventional sale: they could not select the purchaser; they could not determine or affect the price and quantity of any gas the producer might sell; and, as noted above, they had no say about whether the gas would flow to the interstate market or the intrastate market.

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[143] *Id.*

[144] *Id.*

For these reasons, the Court concluded that the landowner's lease was "too far removed from the interstate sale" to constitute a jurisdictional transaction.[145] It held that "an economic interest in the proceeds of a sale, unaccompanied by authority to determine the incidents of the sale, does not make one a seller."[146] By contrast, the producer-lessee would be a natural-gas company subject to regulation by the Commission, the Court said, "because of the interstate movement conducted either by him or by his company."[147]

The *Mobil* decision made it clear that the typical gas lease by a landowner does not bring the landowner within the ambit of the Commission's jurisdiction under the Natural Gas Act. It was also clear after *Mobil* that the landowner does not cross the jurisdictional boundary and become a natural-gas company merely because he retains a royalty that is dependent upon the volume or value of the gas produced, in the absence of power to determine any of the incidents of a wellhead sale.

What else may a landowner do and still elude the Commission's grasp? Not much, it develops—as a recent Fifth Circuit case made clear.

In *Louisiana Land and Exploration Co.* v. *F.E.R.C. (LL&E)*,[148] the Court had before it a landowner (Louisiana Land) which had reserved a fractional royalty interest (*i.e.*, a right to receive a royalty measured by a percentage of the value of the gas produced) when it had made a mineral lease of certain acreage to a predecessor-in-interest of Amoco Production Company (Amoco). The lease prohibited the transfer of the leasehold by the lessee or its successor-in-interest without the written consent of Louisiana Land.

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[145] *Id.* at 263.

[146] *Id.* at 262.

[147] *Id.* at 262, n. 15.

[148] 574 F.2d 204 (5th Cir. 1978), *cert. denied*, 47 U.S.L.W. 3495 (439 U.S. 1127, (1979)).

Subsequently, Amoco proposed to assign its interest in the lease to a jurisdictional natural gas pipeline, Tennessee Gas Pipeline Company (Tennessee). Tennessee was to pay a fixed sum per Mcf produced as consideration for the assignment. Amoco sought Louisiana Land's consent to the assignment. Louisiana Land gave its consent, but only upon condition that Tennessee would agree to transmute Louisiana Land's fractional royalty interest into the right to receive a fixed rate (severance taxes plus 22.5¢ and later 25.0¢) per Mcf of gas. Thus, the parties made a tripartite arrangement, under which Tennessee would produce the gas for injection into its interstate pipeline system and pay both Amoco and Louisiana Land royalties for the gas based directly on the volume of production.

The transaction between Amoco and Tennessee had been the subject of the Supreme Court's decision in *Bastian Bay*.[149] That case had held that the Amoco-Tennessee arrangement was a jurisdictional sale of natural gas under the *Rayne Field* doctrine. In *LL&E*, the Fifth Circuit held that Louisiana Land, the original landowner-lessor, was also engaged in a jurisdictional sale of gas to Tennessee and was required to secure Commission certification in order to do so lawfully.

Louisiana Land naturally relied heavily upon the *Mobil* precedent, contending that its activities were virtually identical with those of the landowner-lessor in that case. The Court of Appeals distinguished *Mobil*, however, pointing out that in the case before it, unlike the *Mobil* situation, the landowner, Louisiana Land, retained the power to block any further transfer of the leasehold rights. The Court expressly refused to decide whether the mere retention of such a power, without any subsequent exercise of it, is sufficient to render the lessor-landowner subject to Commission jurisdiction. Louisiana Land, however, *did* exercise its retained veto power by assenting to the transfer of the leasehold rights it had granted, by

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[149] *F.P.C.* v. *Pan American Petroleum Corp.*, *supra*, n. 117.

signing the agreement among the three parties, and, indeed, by exacting a price for its action. Louisiana Land's exercise of its retained power was, of course, essential in order to carry out the transfer of the gas to Tennessee. As the Court wrote,—

> The exercise of this power was an indispensable ingredient in an indisputably jurisdictional transfer. The exercise of this power was essential to accomplishing the transfer of large amounts of natural gas to an interstate pipeline company for resale in other states and also affected an incident of the sale, the buyer's cost. Moreover, the exercise of the power, coupled as it was with an alteration of the royalty rate, had the effect of altering not only the cost of extracting the gas but also the cost of introducing the gas to commerce. Under these circumstances, we conclude that in economic effect [Louisiana] Land sold gas in interstate commerce subject to FERC jurisdiction. We hold that by retaining a royalty interest in gas extracted from premises leased to Amoco, retaining its power to prevent Amoco from selling its entire interest in proven and developed reserves to a pipeline company, and agreeing to an amendment of the terms of the royalty payments before consenting to the jurisdictional transfer, [Louisiana] Land made a jurisdictional sale of natural gas.[150]

The Court held, correctly, that the *Mobil* precedent mandated the result it reached in *LL&E*. In *LL&E*, the landowner was more than the passive lessor who was before the Court in *Mobil*. Instead, Louisiana Land has retained, and had exercised, authority that affected a number of the incidents of sale of natural gas. By doing so, Louisiana Land actively aided and abetted a concededly jurisdictional transaction. Although both parties started out on the same basis—landowners leasing their land for exploitation of its oil and gas—and both parties retained an economic interest in the exploitation of the land's natural gas reserves, only one of the landowners, Louisiana Land, also retained and exercised rights that affected the identity of the pipeline purchaser of the gas and

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[150] 574 F.2d at 207-08.

the price at which the pipeline purchaser secured the gas. Both of these rights were incidents of a garden-variety wellhead sale. Hence, Louisiana Land's actions placed it across the line that *Mobil* had drawn between the passive landowner-lessor and the active jurisdictional seller of natural gas for resale in interstate commerce. Thus, the result in *LL&E* is thoroughly consistent with the precedent of *Mobil*.

IX

The legal principles fashioned in the *Rayne Field* line of cases, when applied to the facts of this proceeding, lead inescapably to the conclusion that all of the lease-sale agreements at issue are jurisdictional. The crucial test that emerges from the cases is whether a particular transaction accomplished the transfer of large volumes of natural gas reserves to an interstate pipeline for resale in interstate commerce. If it did, the transaction is jurisdictional.

This is so regardless of the manner in which the transaction is structured. If *Rayne Field*, coming as it did after *Panhandle*, taught us anything, it was the necessity of eschewing the tyranny of labels and applying a functional analysis to lease-sale transactions in order to ascertain their jurisdictional character. This method of analysis is mandatory because to do otherwise would tend to frustrate the enacted public policy of the United States. The purpose of the Natural Gas Act, as interpreted in *Phillips*, was to regulate field sales of natural gas to interstate pipelines for resale in interstate commerce. If the format of the transaction rather than its substance (*i.e.*, whether it is cast as a wellhead sale, a lease assignment, or even, as we shall see, a farmout) were deemed critical to a determination of a transfer's jurisdictional character, ingenious lawyers, of whom this industry has little shortage, could surely find a way to evade the jurisdiction of the Federal regulatory agency.

Rayne Field established that such evasion of the purposes of the Act would not be permitted to occur, lest the objectives of Congress be completely and irretrievably thwarted. Six days

later, the Supreme Court in its *Bastian Bay* decision reaffirmed its intention not to permit the exaltation of form over substance to destroy the statutory scheme for regulation of field sales of natural gas.

The jurisdictional character of the contracts at issue in this proceeding follows almost *a fortiori* from the Court's holdings in those two cases and the Fifth Circuit's exegesis on them in *Ship Shoal*. In this context, it is significant that the contracts had their genesis over 30 years ago in the attempt by Delhi to evade Federal Power Commission jurisdiction by restructuring the Barker Dome transaction in the form of a lease-sale agreement. The restructuring of the agreement from a conventional wellhead sale to something apparently different, took place only after Delhi was thrice rebuffed by the FPC in its efforts to secure a declaratory order that the contemplated wellhead sale to El Paso would not render it subject to regulation under the Natural Gas Act. The Barker Dome dealings, though not directly at issue in this proceeding, probably represented a more blatant attempt to evade Federal regulation than the scheme which occurred in the *Rayne Field* case. And the results of the Barker Dome dealings set the pattern for the subsequent lease-sale agreements executed by El Paso and PNW. It is not surprising, therefore, to find that the intentions of the parties to the later agreements mirrored the motivations that shaped the earlier ones between Delhi and El Paso.

Although there were many different and unique features among the GLAs and the PLAs, a number of common threads run through all of them: the structuring of a rather typical gas purchase as a lease-sale agreement with the all-too-convenient effect of escaping Federal regulation (or so it was thought), and—most significantly—the transfer by a producer of large volumes of natural gas reserves ready to be extracted to an interstate pipeline for resale in interstate commerce.

There is no other rational explanation of what was going on. Putting to one side the fine-tuned, hairsplitting, sophisticated distinctions that the respondents are seeking to retail here (we

will come back to them later), a number of things stand out quite bluntly. First of all, the persons who acquired the leases and who sold them to El Paso and PNW were not real estate speculators. For the most part they were producers of natural gas who received their incomes from the sale of natural gas and other hydrocarbons. Secondly, the buyers were not wildcatters, gas and oil producers, or real estate investors. They were—or, in the case of PNW, soon would be—natural gas pipelines in the business of acquiring gas reserves in the field for long-distance transmission and wholesaling in major consuming markets. That is how they earned their incomes. There was no secret about this. Both buyers had, as all parties knew, an urgent need for the wherewithal to demonstrate the dedication of large new gas supplies to their systems in order to obtain regulatory approval for construction and expansion. And, as everyone knew, the new reserve additions could not be speculative. They had to pass muster as certain, sure, and proven before the certificates would issue, the facilities would be built, and (most important) the revenues would flow.

It will not do, therefore, to attempt to characterize the GLAs and PLAs as mere real estate deals between simple country gentlemen. Clearly, something else was afoot—a series of large-scale sales of natural gas in place. There can be little doubt of it.

The record also permits little doubt about the nature and character of the gas reserves transferred by virtue of the lease-sale agreements. At the time El Paso's lease-acquisition program got underway, and certainly by the time PNW began to acquire reserve commitments through lease-sale contracts, knowledgeable people—reservoir engineers and geologists working in the field—well understood that the San Juan Basin in general and, with only a few exceptions, the leaseholds involved in this case, constituted one of the major pools of untapped "gas in place" on the North American continent. It was well known that the Mesaverde formation consisted of blanket pay sands which were ripe for development and which could be expected to underlie virtually all of the respondents'

acreage. True, the cost of producing reserves in the Basin was thought to be somewhat higher than the cost of production elsewhere; that is what accounts for the fact that the interstate pipelines looked to the San Juan Basin only after other major gas producing areas, *e.g.*, the Permian and Hugoton Basins, had become major production centers. The later arrival of the interstate pipelines meant that full-scale development (drilling a well at every available location, for example) had not occurred in most cases by the time the GLAs and PLAs were closed.[151] But that degree of development was not to be expected. Nor is it required to support a finding that the lease-sales were jurisdictional, as *Ship Shoal* made clear. Upon consideration of all the evidence about the state of geological information, it is clear that the volumes of gas involved in this proceeding were definable within reasonable parameters, and that all of the leaseholds at issue here held reserves that were imminently producible in commercial quantities. Events bear out this analysis: shortly after the lease-sale agreements were closed, the acreage was developed, attached to the pipelines, and actually produced volumes of gas in quantities sufficient to supply the requirements of these major interstate natural gas pipelines.

The respondents answer to all of this is to invite the Commission to ignore the *Rayne Field-Bastian Bay-Ship Shoal* trilogy in favor of an atavistic reliance on *Panhandle* and its recent resuscitation in *Mobil*. These last two cases (coupled with some *dicta* in two Fifth Circuit cases[152]) are said to represent the applicable general rule which holds transfers of leases to be

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[151] But note that GLA 125 had more Pictured Cliffs wells on it when closed then it does today.

[152] *J. M. Huber Corp.* v. *Denman*, 367 F.2d 104 (5th Cir. 1966), and *Weymouth* v. *Colorado Interstate Gas Co.*, 367 F.2d 84 (5th Cir. 1966). Both cases *held* only that the question whether a landowner's lease constituted a jurisdictional transaction was within the primary jurisdiction of the Commission.

nonjurisdictional. The *Rayne Field* line of cases, on the other hand, represents a narrow exception to the *Panhandle* doctrine that "leases are an essential part of production," claim the respondents, and should in effect be limited strictly to their facts. Hence, every possible distinction between the lease-sale agreements here involved and the contracts in *Rayne Field*, *Bastian Bay*, and *Ship Shoal* is recited in tedious detail as a basis for finding that the GLAs and PLAs were not economically equivalent to wellhead sales.

The respondents' arguments, in my judgment, stand the governing law on its head. Examination of the cases makes it clear that it is the *Mobil-LL&E* line of cases which represents an exception to the general rule set out in *Rayne Field*, *Bastian Bay*, and *Ship Shoal*, not *vice versa*. That category of exception relates to the jurisdictional status of landowners who make leases to entities in the business of exploring for, and developing, natural gas reserves. The transferors under the GLAs and PLAs, however, were not of the ilk of the landowner-lessors in *Mobil* and *LL&E*. For the most part, they were themselves producers and developers of natural gas reserves. Their dealings in gas-prone real estate have a considerably different cast than those of the landowners. And it follows that the basic premises of the *Mobil* decision do not apply to them. Instead, their rights and obligations are governed by *Rayne Field*, *Bastian Bay*, and *Ship Shoal*, all of which dealt specifically with sales or assignments of leasehold rights by parties situated similarly to the interest owners in this proceeding. Hence, the question which *Mobil* and *LL&E* deemed critical—whether the transferor retained and exercised the power to control the incidents of sale of the gas—is of only limited relevance here.[15a] What is significant is the

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[15a] Even if it were relevant, I would find that, under each of the lease-sale agreements, the interest owner retained sufficient control over the incidents of sale to render him jurisdictional under *Mobil-LL&E*. Since the interest owner was, in each case, dealing with the very pipeline that would acquire the gas for interstate transmission and sale for resale, it could hardly be otherwise.

essential message of *Rayne Field*—that the transfer of large amounts of natural gas reserves to an interstate pipeline for resale in interstate commerce is a jurisdictional transaction, no matter how the lawyers decide to structure the transfer. *Rayne's* specification that "proven and substantially developed reserves" must be present is not a quantitative test, a license for future courts and Commissions to engage in massive well counting in order to ascertain whether some formulaic criterion has been satisfied. Rather, *Rayne* is concerned with commercial realities. It asks whether what was sold was gas or merely the right to explore for and develop it in the uncertain event it is found.

In this context, the term "proven and substantially developed" plainly does not have the connotations with which the respondents would imbue it. They claim that the Supreme Court's use of that term sired a test which must be applied strictly, so that reserves cannot be deemed proven and substantially developed unless the acreage in question is the situs of nearly the maximum number of wells that the law will allow. Nothing else will do, according to the respondents.

In this case, they say, the reserve estimates by DeGolyer and MacNaughton were unreliable, and the geology of the Basin made reliable estimates unattainable in the absence of actual drilling for, and flowing of, gas reserves. The fact that the DeGolyer and MacNaughton reports established the existence of "proven" reserves to the satisfaction of the FPC, and the fact that other, contemporaneous, geological and engineering studies established the existence of "proven" reserves to the satisfaction of the bankers who financed the PNW pipeline are insufficient to establish the existence of "proven" reserves within the meaning of the *Rayne Field* test, according to the respondents. Similarly, the respondents claim that the field was not "substantially developed" for the purpose of the *Rayne* criterion. This omission, they claim, is demonstrated by

comparing a count of the wells extant at closing with the number of wells that were eventually drilled.[154]

From the standpoint of commercial realities, however, all of this is irrelevant to the question at hand: what were the transferees buying? In this proceeding, it is clear that the two pipelines were *not* buying the opportunity to explore several hundred thousand virgin acres in New Mexico and Colorado. They were in the market for gas reserves and nothing else. The critical factor, therefore (the proof of the pudding, as it were), is that these two pipelines were willing to stake large sums of money, their corporate fortunes, and, in one case, corporate viability itself, upon the proven and developed character of the acreage they acquired in the San Juan Basin. This is sufficient to satisfy the *Rayne Field* test.

In addition, as the *Ship Shoal* opinion noted, a requirement that the field must be fully mature as a source of gas production would lead to absurd results and would exclude from the *Rayne Field-Bastian Bay-Ship Shoal* rule the very fact situations that were before the Courts in those cases. The exact volumetric content of any field cannot be determined until after the field is actually producing in substantial volumes (and perhaps can never be known). A field will not actually be made to produce in substantial volumes until there is a pipeline connecting the field with gas markets. A pipeline will not be constructed until the pipeline company has acquired the contractual right to take sufficient reserves of gas from the field to make it worthwhile to incur the cost of construction. Once the pipeline company has acquired that right through wellhead sale contracts, it has no need to acquire the reserve commitments through lease-sale agreements. Hence, under the inexorable logic of the criteria that the respondents would have

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[154] In addition, respondents rely upon the fact that an infill drilling program in the Basin took place long after the acreage was transferred to El Paso and PNW and substantially increased the number of wells on the acreage.

the Commission apply, there would never be a case in which a pipeline would enter into a lease-sale arrangement that is jurisdictional. Yet, history teaches us that there have been such cases.

The respondents claim that the lease-sale agreements at issue in this proceeding are vastly different from the typical gas purchase contract and the type of contract involved in the *Rayne Field* case. They assert that the GLAs and PLAs "were tailored to meet special needs and circumstances which could not have been met by a sale of gas in place."[155] In an effort to buttress this assertion, the respondents point to a variety of provisions in the GLAs and PLAs that are not usually found in a conventional gas purchase contract and that were also absent from the *Rayne Field* contracts. Contrariwise, the respondents point to a number of provisions in the *Rayne* contracts that are absent from the GLAs and PLAs. Respondents urge that these differences among the two groups of agreements bespeak differences in the assumption of economic risks by the parties and conclusively demonstrate that none of the GLAs and the PLAs can be regarded as the economic equivalent of a jurisdictional sale, whether the sale takes the form of a conventional wellhead sale or a *Rayne*-type sale of gas in place.

One difficulty with this argument is that it asks the impossible. Rarely are two contracts exactly the same in all respects. The likelihood that two different sets of negotiators will make two identical contracts is virtually nil. It is equally clear that the Supreme Court in *Rayne* did not sit to construe the contract involved in that case and none other. The *Rayne Field*, *Bastian Bay*, and *Ship Shoal* contracts, all of which were held jurisdictional under judicial scrutiny, differed in many respects.

Even the GLAs and PLAs themselves differ in their terms. For purposes of the *Rayne Field* rule, however, these varia-

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[155] Initial Brief of Designated Respondents, p. 48.

tions are minor and insignificant in the overall perspective. As the Supreme Court noted,

> There are differences, to be sure, between the original [wellhead] sale agreements and the lease-sale plan * * *. But it is perfectly clear that the sales of these leases in Rayne Field * * * accomplished the transfer of large amounts of natural gas to an interstate pipeline company for resale in other States. *That is the significant and determinative economic fact.*[156]

Here, too, the significant economic fact that will not go away no matter how much the respondents try to wish it away is that the GLA and PLA contracts at issue, each and every one of them, transferred large volumes of natural gas from a producer of natural gas to an interstate natural gas pipeline for transmission and sale for resale in other states. That fact requires the finding that each of the contracts was, as a matter of law, economically equivalent to a wellhead sale of natural gas for resale in interstate commerce.

One of the respondents' main lines of defense in this proceeding was that they were compelled by circumstances to enter into the lease-sale agreements which we know as GLAs and PLAs. Essentially, it is their position that El Paso, alone and later in combination with PNW, enjoyed a monopsonistic position in the San Juan Basin during the period when the agreements were negotiated. They claim that because of their vastly superior bargaining power as the only major pipelines in the Basin (and hence the only possible market for substantial volumes of natural gas), these two pipelines were able to dictate the going price being offered for wellhead sales. The price the pipelines set, it is said, was too low to enable the producers profitably to develop and produce the reserves underlying their leases. Hence, the producers conclude, they had no realistic option except to accede to the pipelines' offers to enter into lease-sale transactions. The respondents also

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[156] 381 U.S. at 401 (emphasis added).

contend that it was the *pipelines* that insisted on lease-sale acquisitions, knowing that, because their rates were regulated on a cost-of-service basis, they could simply pass the relatively high cost of San Juan Basin production along to the ratepayers.

The record does not, however, support the assertion that either El Paso or PNW, or both, possessed monopsonistic market power in the San Juan Basin during the relevant period. All that the record shows is that El Paso was the sole major interstate pipeline whose facilities had reached the Basin for a period, until the entry of PNW, after which there were two.[137] This is, however, a far cry from the showing that the respondents claim. There is simply no substantial evidence that the bargaining power of the pipelines, alone or in combination, was any greater than the bargaining power of the interest owners. If the record shows anything on this point with clarity, it indicates that El Paso and PNW were the parties who were desperate to make a deal, since they had an urgent and immediate need for gas reserves to support the applications which they had pending before the Federal Power Commission throughout the relevant period.

Furthermore, the argument, even if one grants its factual premise, proceeds from an erroneous conception of the law. The respondents would have the Commission hold that an otherwise jurisdictional lease-sale arrangement ceases to be jurisdictional because the seller would have preferred to make a conventional wellhead sale and was compelled to enter into the lease-sale by the overweening power of the buyer. This is

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[137] There were some local outlets for gas sales—*e.g.*, Southern Union Gas Company purchases for the intrastate market, minor purchases for field use—even before El Paso reached the San Juan Basin. The volumes demanded by these buyers were too small to constitute a significant market for the Basin's producers, however. In asserting that large-scale production could not take place until major interstate pipeline facilities arrived in the Basin the respondents are quite correct.

simply neither logical nor correct. Under *Rayne Field*, it is the economic effect of the transaction which is the touchstone of jurisdictional status. The motives with which the parties consummated the arrangement are irrelevant. Hence, even if we assume, *arguendo*, that the pipelines compelled the interest owners to enter into the GLA and PLA contracts through some sinister machinations or the assertion of irresistible economic power, that finding would not detract one iota from the conclusion that the contracts were subject to the regulatory jurisdiction of the Commission under the Natural Gas Act.

Similarly, the respondents' persistent assertions that the pipelines have been guilty of immoral profiteering, gross violations of the antitrust laws, failure to live up to bargains which they welcomed in more halcyon days, and inconsistent (and possibly perjurious) statements to the Commission about the character of the lease-sale agreements are all irrelevant to the issues which must be decided in this proceeding. This is not an area of the law where there is one rule for the party who wears the black hat and another for the party who wears the white hat. The *Rayne Field* doctrine, in short, is not a rule which is dependent upon normative behavior. It applies regardless of the moral character of the party who is detrimentally affected by it. And when, as here, it renders lease-sale agreements jurisdictional, it falls, as the biblical rain from heaven, on the just and the unjust alike.[15a]

* * * * * *

Notwithstanding the conclusion that all of the lease-sale agreements at issue are jurisdictional sales of gas as a matter of law, there are some lease-sale arrangements which merit special attention. One is the group of GLAs that was the subject of the Federal Power Commission's Opinion No. 642. The other is GLA 62 between El Paso and Blackwood & Nichols Company.

[15a] *Matt.* 5:45.

As we have noted above,[159] Opinion No. 642 held, in effect, that the Natural Gas Act did not confer regulatory jurisdiction over nine GLAs between El Paso and the so-called *Webb-Turner* parties.[160] In the order initiating these proceedings, however, the Commission ordered that the jurisdictional issues previously decided in Opinion No. 642 should be relitigated and redetermined *de novo*.[161]

The *Webb-Turner* parties, who were somewhat less than overjoyed at the prospect, petitioned the Commission for rehearing, arguing that Opinion No. 642 was *res judicata* and that, in any event, the commission is now collaterally estopped from retrying *de novo* issues that had been decided in 1973, when Opinion No. 642 was issued. The Commission rejected both branches of the argument. It held that neither the doctrine of *res judicata* nor the principle of collateral estoppel precludes *de novo* review of the jurisdictional issues decided in Opinion No. 642.[162] The *Webb-Turner* parties sought judicial review of the Commission's action exposing them to relitigation of the jurisdictional issues that had been decided in Opinion No. 642. However, the Court of Appeals for the Fifth Circuit ruled that it would stay its hand pending the Commission's disposition of the merits of those issues in this proceeding.[163]

At the initial prehearing conference, counsel for William G. Webb *et al.*, announced that his clients would not present any

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[159] *Supra*, at mimeo 6-7.

[160] The specific agreements are identified in the table at mimeo pp. 30-33, *supra*.

[161] Order Instituting Proceeding, *supra* at mimeo p. 5, n.6, at mimeo p. 8.

[162] Order on Rehearing, *supra* at mimeo p. 7, n.14, at mimeo, pp. 4-6.

[163] See discussion at mimeo pp. 9-10, *supra*. The Court had consolidated the *Webb-Turner* parties' petition with other petitions seeking immediate review of the FPC's decision to send this proceeding to hearing and with the appeal from the District Court's judgment in *El Paso Natural Gas Co.* v. *Sun Oil Co.*, 427 F. Supp. 963 (W.D.

evidence in this proceeding but would rely instead on Opinion No. 642.[164] True to their word, the *Webb-Turner* parties did not participate in the evidentiary hearing. They have, however, submitted a post-hearing brief, in which they reiterate their contention that the Commission is bound by the FPC's determination in Opinion No. 642 to hold that their lease-sale agreements are nonjurisdictional.

It would indeed be interesting to consider whether, and the extent to which, the Commission is bound to adhere to the view it took in Opinion No. 642 by virtue of the doctrines of *res judicata* or collateral estoppel or under principles of elemental fairness deriving their applicability from the Constitution, the Administrative Procedure Act, or both. For one thing, the relevant cases on the application of doctrines such as collateral estoppel to administrative proceedings are of relatively recent vintage.[165] And it is entirely possible that the rules that apply to an agency which, like the Board of Contract Appeals in the *Utah* case,[166] is acting purely in an adjudicative capacity do not apply to an agency which, like the Commission in this proceeding, is conducting an investigation for the purpose of ascertaining whether there has been a violation of the statute it is charged with administering.

Interesting though these questions may be, they are not proper subjects for discussion in this Initial Decision. That is the case because the Commission in its order instituting this

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Tex. 1977). Its September 6, 1978 order withholding decision apparently applies to all of the consolidated cases. On October 25, 1978, the Court of Appeals responded to a motion for clarification by saying that Webb "will, along with all other parties to [the FERC] proceeding, be affected and bound by the action of the Commission and, an appeal or review by this Court, by orders of this Court."

[164] Tr. 31.

[165] *E.g.*, *United States* v. *Utah Constr. & Mining Co.*, 384 U.S. 394 (1966).

[166] *Id.*

proceeding and in its order on rehearing thereof made it quite clear that, in its view, none of the preclusionary doctrines which accord finality to prior adjudication apply to the *Webb-Turner* parties in this proceeding. The Commission has, in short, affirmatively and definitely decided that the hearing and disposition of the jurisdictional issues affecting the *Webb-Turner* parties is to be *de novo* and on the merits. That being so, the Presiding Administrative Law Judge, under well-settled principles, is not at liberty to ignore or impugn the Commission's determination. He is bound by it.

Three things follow. First, the correctness of the position taken by the *Webb-Turner* parties can not, and will not, be treated in this Decision. Second, those parties, if they desire to press their arguments to final disposition, must put them again to the Commission on exceptions to this Decision.[167] Finally, the *Webb-Turner* GLAs must be weighed in the same balance as the other lease-sale contracts *sub judice*. Applying that standard to the *Webb-Turner* agreements, it is clear that they do not differ from the other GLAs and the PLAs in any significant, relevant respect. They, too, accomplished the transfer of natural gas to an interstate pipeline for resale in interstate commerce. Hence, I conclude that the *Webb-Turner* agreements are jurisdictional.

The jurisdictional character of GLA 62 between El Paso and Blackwood & Nichols Company is also governed by the rules generally applicable to the other lease-sale agreements at issue here. This is the case despite the efforts of the present interest owner, F.H.N., Ltd., to confer special, unique status upon this particular GLA.

Before El Paso came upon the scene, Blackwood & Nicols had acquired their rights to the acreage by executing a farmout agreement with one W. E. Alsup, the owner of four leases covering acreage in Rio Arriba County, New Mexico.[168] The

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[167] See 18 CFR 1.31.

[168] Under a farmout agreement, the owner of the working interest assigns it to some other party (the "farmee") who is presently willing

agreement provided for Alsup to assign to Blackwood & Nichols at least two of the nine tracts covered by his leases.[169] Alsup reserved an overriding royalty of 5% on all hydrocarbons produced. Blackwood & Nichols agreed to pay Alsup $15.62 per acre at the closing and promised to drill a Pictured Cliffs well on each tract. The agreement also gave Blackwood & Nichols the exclusive option to purchase the right to develop additional tracts, at the same price of $15.62 per acre and the same 5% royalty obligation, for three years after the date of closing.[170]

Ultimately, after having drilled two Pictured Cliffs wells (one of which was plugged and abandoned) and having expended some $220,000 on unsuccessful development operations, Blackwood & Nichols grew discouraged and sought to sell its rights in the Alsup properties to El Paso.[171] The result was GLA 62, under which Blackwood & Nichols assigned its entire interest in the Alsup farmout agreement to El Paso, reserving a per-Mcf overriding royalty similar to the type of royalty previously reserved by other GLA interest owners in the San Juan Basin.[172]

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to develop the acreage. Commonly, the farmee is entitled to retain all revenues from the sale of hydrocarbons extracted from the property until he has recovered his costs of developing it. After that point—termed "payout"—is reached, the farmer receives a fractional overriding royalty on all hydrocarbons produced from the acreage. He may be entitled to convert the royalty into a working interest.

[169] Exh. 2, "Letter from Blackwood & Nichols Co. to Mr. W.E.Alsup, dated April 30, 1951." The first tract was designated in the agreement. The second tract, which was to be selected by Blackwood & Nichols, was to be assigned at a later date.

[170] *Id.*

[171] Designated Respondents' Proposed Findings of Fact, Tab H, No. 20, p. 4. See also Responses of Complainants to Designated Respondents' Proposed Findings of Fact, Tab H, No. 20, p. 2.

[172] See Exh. 2, "Oil and Gas Lease Sale Agreement." The other terms of the lease-sale agreement were also similar to those executed by other interest owners during El Paso's GLA-acquisition program.

F.H.N., Ltd., the successor to the rights and obligations of Blackwood & Nichols, now contends that GLA 62 should be accorded special treatment. The gravamen of F.H.N.'s position is that because all that Blackwood & Nichols had to convey to El Paso was its interest as farmee under a farmout agreement, Blackwood & Nichols could not have possibly made a jurisdictional sale of gas in place.

Nowhere is it explained why the position of farmee is inherently inconsistent with the role of seller of natural gas to a pipeline for resale, however. To the contrary, since no party to a farmout can receive any revenue unless gas produced from the acreage is sold, it would seem self-evident that the farmee, as the party empowered to exercise the working interest, has every right to sell the gas. Unless there is something in the farmout agreement which prohibits him from doing so (and no such provision has been cited to me), the farmee would be at liberty to negotiate and consummate a sale of the gas in place, just as he would be empowered to make a conventional wellhead sale of the gas. The fact that there are other parties with an interest in the leasehold who are not privy to the farmee's dealings with the pipeline purchaser does not in any way detract from the capacity of the farmee and the pipeline, by virtue of their agreement, to make a sale for resale that is subject to all of the provisions of the Natural Gas Act, thereby binding all interested parties.[173] There is, in short, no magic in the term "farmout" or in the status of "farmee" that would warrant different treatment for GLA 62 than for the lease-sale agreements.

Accordingly, I hold that, notwithstanding its unusual origins, and even though it is not technically a "lease" - sale, GLA 62 as a matter of law accomplished a sale of natural gas for resale in interstate commerce and is therefore subject to regulation under the Natural Gas Act.

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[173] *Cf. California* v. *Southland Royalty Co.*, 436 U.S. 519 (1978).

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For the foregoing reasons, I find that the lease-sale agreements between the respondents and the complainants constituted sales of natural gas for resale in interstate commerce. As those sales were made without certificates of public convenience and necessity and, in many instances, at rates exceeding the just and reasonable rates prescribed by the Federal Power Commission and the Federal Energy Regulatory Commission, the parties to the lease-sale agreements are subject to sanctions and remedies as provided by the Natural Gas Act.

WHEREFORE, *It is ordered*, subject to review by the Federal Energy Regulatory Commission on appeal or upon the Commission's own motion as provided in the Commission's Rules of Practice and Procedure, that such further and additional hearings as are necessary shall be held for the purpose of determining, in accordance with the Administrative Procedure Act, the sanctions that shall be applied and the orders the Commission shall enter to provide appropriate remedy for the violations of the Natural Gas Act specified above.

ISAAC D. BENKIN,
Presiding Administrative Law Judge.

4. OPINION OF THE UNITED STATES DISTRICT COURT FOR THE WESTERN DISTRICT OF TEXAS, *EL PASO NATURAL GAS CO.* V. *SUN OIL CO.*, 426 F. SUPP. 963 (JANUARY 27, 1977)

UNITED STATES DISTRICT COURT,
W.D. TEXAS, MIDLAND-ODESSA DIVISION.
JAN. 27, 1977

No. MO-74-CA-57.

EL PASO NATURAL GAS COMPANY,
Plaintiff,

PACIFIC NORTHWEST PIPELINE CORP., *et al.*,
Intervenors,

v.

SUN OIL COMPANY, *et al.*,
Defendants.

Producer of natural gas for interstate market to which certain working interests in oil and gas properties had been transferred under gas lease agreement brought action for declaratory judgment that the owners of the working interests transferred to producer must first seek certification from Federal Power Commission before they could collect overriding royalties in excess of regulated interstate rate. The District Court, Suttle, J., held, inter alia, that the agreements at issue were not sales in interstate commerce of natural gas for resale within meaning of Natural Gas Act, that there had been no violation of Act and that court lacked jurisdiction over subject matter.

Case dismissed.

Paul R. Connolly, J. Alan Galbraith, William E. McDaniels, Williams, Connolly & Califano, Washington, D.C., Charles Sapp, W. Robert Brown, Liddell, Sapp, Zivley & Brown, Houston, Tex., Richard S. Morris, Harris S. Wood, El Paso Natural Gas Co., El Paso, Tex., for El Paso Natural Gas Co.

David K. Watkiss, Watkiss & Campbell, Salt Lake City, Utah, Daniel F. Collins, Ross, Marsh & Foster, Washington,

D.C., James M. O'Leary, Shafer, Gilliland, Davis, Bunton & McCollum, Odessa, Tex., for intervenor, Northwest Pipeline Corp.

Rufus G. Thayer, San Francisco, Cal., for intervenor, People of the State of Cal. and Public Utilities Commission of the State of Cal.

Thomas F. Brosnan, John F. Harrington, Gallagher, Connor & Boland, Washington, D.C., for intervenors, Tucson Gas & Elec. Co., Washington Natural Gas Co., Southern Union Gas Co.

Leonard L. Snaider, C. H. McCrea, Las Vegas, Nev., for intervenor, Southwest Gas Corp.

Howard V. Golub, Donald L. Freitas, San Francisco, Cal., Jack Q. Tidwell, Deaderick, McMahon, Cox, Todd & Tidwell, Odessa, Tex., for intervenor, Pacific Gas & Elec. Co.

Ed M. Cage, Herf M. Weinert, G. David Neal, Dallas, Tex., Leo J. Hoffman, Strasburger, Price, Kelton, Martin & Unis, Dallas, Tex., W. B. Browder, Jr., Stubbeman, McRae, Sealy, Laughlin & Browder, Midland, Tex., for Sun Oil Co.

George B. Mickum, III, Steven H. Brose, Steptoe & Johnson, Washington, D.C., Edward J. Kremer, Jr., Horace N. Burton, Dallas, Tex., W. B. Browder, Jr., Midland, Tex., for Atlantic Richfield Co.

Robert D. Haworth, Mobil Oil Corp., Houston, Tex., Philip R. Ehrenkranz, Craig W. Hulvey, Grove, Jaskiewicz, Gilliam & Cobert, Washington, D.C., W. B. Browder, Jr., Midland, Tex., for Mobil Oil Corp.

W. A. Schneeberg, American Petrofina Co. of Texas, Dallas, Tex., Gordon Gooch, Charles M. Darling, Baker & Botts, Washington, D.C., W. B. Browder, Jr., Midland, Tex., for American Petrofina Co. of Texas.

James J. Dawson, Gene Burke, Cable, McDaniel, Bowie & Bond, Baltimore, Md., Gordon Gooch, Washington, D.C.,

W. B. Browder, Jr., Midland, Tex., for Crown Petroleum Corp.,

Edward Kliewer, Jr., Kliewer & Hood, Dallas, Tex., Gordon Gooch, Washington, D.C., for Delta Drilling Co. (Delta Drilling Corp.)

Dee H. Richardson, Union Oil Company of Cal., Midland, Tex., Platt W. Davis, III, Michael J. Henke, Vinson, Elkins, Searls, Connally & Smith, Washington, D.C., W. B. Browder, Jr., Midland, Tex., for Union Oil Co. of Cal.

Lionel E. Z., Cohen, Tulsa, Okl., Gordon Gooch, Washington, D.C., for Mr. and Mrs. Morris Mizel.

Vernon M. Turner, Houston, Tex., Millard F. Carr, Tenneco Corp., Denver, Colo., Gordon Gooch, Washington, D.C., W. B. Browder, Jr., Midland, Tex., for Tenneco Corp.

Thomas H. Burton, Jr., Continental Oil Co., Houston, Tex., Gordon Gooch, Washington, D.C., W. B. Browder, Jr., Midland, Tex., for Continental Oil Co.

W. B. Browder, Jr., Midland, Tex., for W. Watson LaForce, Jr., et al.

MEMORANDUM ORDER

SUTTLE, District Judge.

This is a suit under the Natural Gas Act of 1938.[1] Its genesis is in the differential between the unregulated price of intrastate gas and the regulated price of interstate gas. El Paso Natural Gas Company produces natural gas for the interstate market. Plaintiffs claim that the Defendants must first seek certification from the Federal Power Commission (FPC) before they can collect overriding royalties in excess of the regulated interstate rate. Plaintiffs seek a declaratory judgment[2]

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[1] 15 U.S.C. § 717 *et seq.*

[2] El Paso originally sought declaratory relief in the United States District Court for the District of Columbia. El Paso brought suit after Sun was awarded a 40 cent per Mcf overide. (See Finding of Fact 16,

that Defendants are natural gas companies selling gas for resale in interstate commerce. The suit reduces to the following proposition.[3]

> Where certain agreements, by which lessees transferred working interests in oil and gas properties to a regulated pipeline, provided for payments of overriding royalties on a scale initially set at a certain number of cents per Mcf of production and escalated that amount per Mcf over an initial term of years, and provided for arbitration of the amount of payments after the initial term if the parties were unable to agree on the amount, and where a subsequent arbitration award placed the amount of the override payments in excess of the FPC regulated price, are those agreements "sale[s] in interstate commerce of natural gas for resale" within the meaning of § 5 of the Natural Gas Act of 1938 (15 U.S.C. § 717d)?

Since this Court's jurisdiction coincides with the FPC's jurisdiction over "sale[s] in interstate commerce of natural gas for resale," from January 21 to March 4, 1976, this Court heard evidence to determine its jurisdiction.[4] Between April 23 and April 27, 1976, the Court heard arguments on the evidence. On

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infra). As the other Defendants sought to increase the level of their overrides, (See Finding of Fact 17, *infra*) El Paso brought individual actions against each of these Defendants. The United States District Court for the District of Columbia consolidated all those individual cases. The consolidated case was transferred to the Western District of Texas under the provisions of 28 U.S.C. § 1406.

[3] Contract analysis would reduce the case to the following proposition:

> Does El Paso bear the risk of the FPC determining that the level of overrides is unjust and unreasonable, or do the Defendants bear that risk?

See Initial Decision on Disputed Issues (FPC Docket RP73-109, *et al.*, opinion issued September 29, 1976). A determination that Defendants were "natural gas companies" would shift the risks of an adverse FPC determination to the Defendants.

[4] 15 U.S.C. § 717u; *see* 15 U.S.C. §§ 717c(a), (c); 717a(6); 717(b).

November 22, 1976, the Court heard arguments on the law. The Court concludes that it lacks jurisdiction and enters the following findings of fact and conclusions of law.

FINDINGS OF FACT

(1) Plaintiff El Paso Natural Gas Company (El Paso), a regulated interstate pipeline, is producing natural gas from its own leases in the San Juan Basin (Basin). In July 1950, the FPC certified El Paso to build a natural gas transmission line from the Barker Dome Field in the Basin to California. FPC certification established El Paso as the dominant economic force in the Basin, because El Paso, the only pipeline having access to interstate markets, was the only potential purchaser of Basin gas. After certification, El Paso acquired extensive leasehold interests in the Basin,[5] including the leaseholds involved in this litigation. All the agreements at issue in this case were executed after El Paso had completed its transmission line.

(2) The Defendants were originally lessees[6] holding working interests in certain oil and gas properties in the Basin. Under agreements denominated Gas Lease Agreements (GLAs) the Defendants transferred certain of their working interests to El Paso.

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[5] Because the Barker Dome transaction (GLA-32) was negotiated before El Paso was certified, the history of the Barker Dome agreement is not analogous to the agreements here at issue. In any regulated industry, entry into the market through certification is probably the most critical step. The negotiations surrounding Barker Dome reflect El Paso's efforts to enter the San Juan Basin. Once El Paso was certified, it held a virtual monopsony in the Basin since Southern Union Gas Company, the only other pipeline in the Basin, served only intrastate markets which were already fully utilized.

[6] Defendants in many instances are successors-in-interest to the original lessees who negotiated the GLAs. Because being a successor-in-interest is of no legal significance, the current interest holders are treated as having been the original lessees.

(3) The GLAs in issue (GLAs 47, 52, 60, 61, 63, 66, 76, 78, 106, 125, 129, 172, 348 and 349) provided that El Paso would receive the rights to develop and market natural gas in one or more productive formations.[7] The agreements typically provided[8] that:

(a) El Paso was obligated to drill each 320 acre drilling unit on the acreage transferred. If El Paso failed to drill a 320 acre unit, the unit reverted to the lessee.

(b) El Paso was obligated to pay for wells located on the property which met a certain specified productivity.[9]

(c) El Paso had the option of returning acreage which proved to be noncommercial.

(d) El Paso was obligated to make a minimum payment if the amount of overrides on gas produced were less than that minimum amount.[10]

(e) El Paso was obligated to pay an amount per Mcf that was equivalent to the amount El Paso paid for similar gas under similar agreements; i.e. a favored nations clause.

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[7] The Pictured Cliffs and the Mesa Verde were the formations most commonly transferred. GLAs 348 and 349 conveyed only interests in the Dakota formation because rights to the Pictured Cliffs and Mesa Verde in the same acreage had previously been conveyed by GLA-76. Certain agreements transferred fee leases instead of transferring productive horizons because the acreage was Indian tribal land which could not be transferred horizon by horizon.

[8] In GLAs 125 and 129 the lessee developed the properties and incidentally assumed the risks of dry holes. GLAs 125 and 129 provided the lessee with an option to transfer acreage to El Paso on a well by well basis. Both GLAs 125 and 129 had total production payments based on the estimated reserves of gas in place, and provided for the redetermination of reserves. (*See* Finding of Fact 20, *et seq.*, *infra*).

[9] GLAs 125 and 129 gave lessees options to transfer on a well by well basis. (See Finding of Fact 20, *infra*).

[10] GLA 63 had no minimum take or pay provision; instead, GLA 63 provided for a ratable take of gas.

(4) El Paso was obligated to pay an overriding royalty of a specified number of cents per Mcf of production. The amount to be paid per Mcf escalated over a fixed period of time (initial term). After the initial term expired, the amount of the override was to be redetermined by the parties. If the parties were unable to agree on the amount of the override payments, they were obligated to arbitrate.

(5) No agreement at issue specified an up-front payment tied to an estimate of reserves.[11]

(6) The San Juan Basin is a distinct geological entity located in the four corners area of New Mexico and Colorado. The Basin takes its name from its structure. In cross-section, the Basin is a bowl shaped depression. Formations lying several thousand feet below the surface at the center of the Basin rise to the surface at its edge. The surface outcrops of the formations mark the Basin's perimeter.

(7) Three formations in the Basin are gas productive.[12] From the shallowest to the deepest formations are the Pictured Cliffs, the Mesa Verde, and the Dakota. All three formations are tight in that each formation is characterized by low to moderate permeability and low porosity.

(8) Recovery of natural gas from each productive formation is a function of the variations in the permeability and in the porosity of the formation. Because the Basin's geologic structure does not reveal those variations in any productive forma-

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[11] The Barker Dome Agreement (GLA-32) provided for an up-front payment. *See United Gas Improvement Co.* v. *Continental Oil Co.*, 381 U.S. 392, 85 S.Ct 1517, 14 L.Ed.2d 466 (1965); *Federal Power Commission* v. *Pan American Petroleum Corp.*, 381 U.S. 762, 85 S.Ct. 1802, 14 L.Ed.2d 714 (1965); *Continental Oil Co.* v. *Federal Power Commission*, 370 F.2d 57 (5th Cir. 1966), *cert. denied*, 388 U.S. 910, 87 S.Ct. 2114, 18 L.Ed.2d 1349 (1967).

[12] The productive area of each formation does not extend to its surface outcrop.

tion, geologic structure has little or no direct influence upon the localization of recoverable gas reserves. Actual drilling is the only method of locating recoverable gas saturations.

(9) Because the productive formations are tight, even where drilling located recoverable reserves, completed wells delivered gas in low volumes.

(10) Two consequences do flow from wells in the Basin because large volumes of gas do not. First, drilling costs are significantly higher because more wells have to be drilled to supply a pipeline with commercially significant volumes of gas. Second, where the drilling costs are recouped out of the volume of gas sold, those costs are recovered more slowly for wells of low deliverability than for those of high deliverability.[13]

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[13] For a specific leasehold a producer recovers the costs of drilling, including the costs of unsuccessful wells, by selling gas. In view of the low average deliverability of successful wells, the risks of unsuccessful drilling, the low prices El Paso offered for gas and the absence of any other buyer, no producer had any reasonable assurance of drilling commercial wells in the San Juan Basin.

El Paso, on the other hand, earned a rate of return on capital invested in successful wells. Since that capital account was depreciated on units of production, El Paso's capital accounts remained higher the more slowly successful wells delivered gas. El Paso was also able to expense the costs of unsuccessful wells. El Paso was able to pass the risk of unsuccessful drilling on to its customers.

> "Under this method [cost of service], the natural gas in place and the properties and equipment utilized in producing it are included in the rate base, along with the transmission, compression, and other facilities employed in transporting and selling it to the customers, at the net investment which they represent, *i.e.*, their original cost less the reserves that have been accrued to cover their depreciation and depletion. In addition to a rate of return thereon equal to the rate of return found reasonable for the pipeline operation overall, there are included in the recoverable costs of service, upon which the charges to jurisdictional customers are based, all operating expenses chargeable to production, including such uncapitalized exploratory and development outlays as delay rentals, geological surveys, and the ex-

(11) Some properties had no drilled acreage when the respective GLA was executed. For those properties that had drilled acreage when the respective GLA was executed, the number of wells drilled was quite small in relation to the number of drilling spaces available.

(12) During the 1950's and into the 1960's, El Paso spent substantial sums developing properties it had acquired in the Basin.

(13) During each GLA's initial term, El Paso paid the specified overrides for volumes produced from the respective properties.

(14) After initial term of each GLA had expired, El Paso continued to pay overrides at the highest rate set out in the original agreement.

(15) When, in 1973, the level of the override for GLA 61 was to be determined again, Sun Oil Company (Sun) and El Paso could not agree on the level of that override. The parties proceeded to arbitration.

(16) A Board of Arbitrators awarded Sun an override of a 40 cents per Mcf. The amount of the override was based on the wellhead value of gas. The Board calculated the wellhead value of gas using the market value of intrastate gas instead of the regulated interstate rate. This override award exceeded the FPC regulated price for San Juan gas of similar vintage.

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penses of drilling dry holes. Thus all the costs and risks incurred in the search for gas by a pipeline are shifted from (stockholders) to the customers of the pipeline. In addition, all expenses associated with the extraction of liquid hydrocarbons . . . are also included among the allowable operating expenses, but corresponding production credits are made of the revenue from the sale of such products. Under the rate-base approach allowances for taxes on the production property are made in accordance with the actual payments made thus transferring to the rate payer all the savings of federal income taxes permitted by statute to be enjoyed by gas producers through allowances made for depletion and intangible well drilling costs." (Opinion 568, 42 FPC 738, 756 (1969)).

(17) The interest holders under other GLAs at issue demanded an override of 40 cents per Mcf. They claimed that the arbitrator's award to Sun triggered the favored nations clauses in their own agreements.

(18) No Defendant sought a certificate from the FPC before asserting his right to collect a 40 cent per Mcf override.

(19) In its rate cases El Paso had always treated the volumes of gas produced from the properties at issue as having been produced from its own properties and never as having been purchased under gas sales contracts.

(20) GLA-125 interest holders began receiving overrides after excercising options to transfer producing wells to El Paso. The interest holders sought certificates of abandonment from the FPC, because prior to exercising those options they had been selling gas to El Paso under gas sales contracts.[14]

(21) El Paso was a party in the *Webb-Turner*[15] litigation. When El Paso took over the GLA-125 leases, El Paso sought to include in its rates its actual costs for producing gas from the GLA-125 properties. El Paso's production costs were higher than the area rates. The Staff of the FPC and the State of California claimed that El Paso was entitled only to area rates for the gas produced on GLA-125 properties. Their theory was that GLA-125 was actually a gas sales contract like *Rayne Field*[16] and that the transaction should be considered a sale of gas.

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[14] *Webb-Turner*, Opinion 642, 49 FPC 17 (1973).

[15] *Id.*

[16] *United Gas Improvement Co.* v. *Continental Oil Co.*, 381 U.S. 392, 85 S.Ct. 1517, 14 L.Ed.2d 466 (1965).

(22) After litigation of the issue, the FPC concluded that El Paso could include its actual costs in its rate rather than being limited to the lower area rates because:

> "the . . . transactions [GLA-125] should not be considered equivalent to *Rayne* transactions because they arose under different circumstances. . . ."[17]

The opinion specifically found that GLA-125 differed from *Rayne Field* in that GLA-125 did not transfer proven and substantially developed acreage:

> ". . . there was a transfer of natural gas in the form of reserves to an interstate pipeline company for resale, but the transactions here represented a method evolved by El Paso and the Producers to cause the exploration for and the development of necessary gas supplies. By entering into the option agreements, El Paso was not buying developed reserves but arranging to have certain leases in the San Juan explored and developed by the producing interests, who were given an option to transfer the leases to El Paso provided the wells met initial productivity tests specified in the option agreements."[18]

No appeal was taken from the decision.

(23) The GLAs in issue were not transfers of leases with proven reserves, since no reasonable estimate of recoverable reserves underlying the specific acreage conveyed could be made at the time its respective GLA was executed. Because insufficient drilling had been done to prove up reserves in the specific acreage transferred, the GLAs in issue were not agreements to transfer definable volumes of reserves. Actual drilling was the only method of locating and defining recoverable gas saturations on specific acreage.[19]

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[17] 49 FPC at 26.

[18] *Id.*

[19] When El Paso increased its transmission facilities, El Paso, its creditors and the FPC were relying on the conclusion of DeGolyer & McNaughton (D&M) that plenty of gas existed in the Blanco-Largo

The GLAs themselves indicate that the parties negotiated for acreage containing unproven reserves. First, each GLA granted El Paso the option of returning drilling sites that proved to be uncommercial. Second, no GLA provided for an up-front payment based on an estimate of recoverable reserves. Even though El Paso was bargaining from a superior position, had the parties been bargaining for proven reserves, up-front payments and no option to return would have been included in the GLAs.

(24) Because little if any actual drilling had been done on any acreage when its respective GLA was executed, each GLA was an agreement to transfer acreage which was not substantially developed. Where wells had been drilled, the number was exceptionlly low compared to the number of available drilling sites. Wells in the Basin generally were incapable of recovering commercially significant amounts of gas. Not only were these wells generally of such low deliverability that a producer could not hope to recoup his drilling costs, but also a significant amount of drilling remained to be done to supply a

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field. D&M's analysis implied that over the entire field commercially recoverable accumulations of natural gas existed. The most that could be inferred from D&M's analysis, however, was that over the entire field there would be an average rate of success in drilling for commercially recoverable accumulations of natural gas. The report did not show, nor coult it be inferred from D&M's analysis wheher or not specific acreage would contain commercially recoverable reserves; i.e. proven reserves.

The D&M report points out the qualitative difference in the risk of drilling undertaken by El Paso, apart from El Paso's ability to pass that risk on (*see* note 13 *supra*) and that undertaken by any other producer. The more acreage El Paso developed in the Basin the closer it could come to D&M's average recovery rate (assuming D&M to be correct). Any other producer had a higher risk than El Paso because he took the drilling risks on a limited amount of acreage, and was simply not in a position to spread his risks over the entire field to insure an average recovery rate.

pipeline with commercially significant volumes of gas. The GLAs themselves indicate that the parties negotiated for undeveloped acreage. El Paso undertook extensive burdensome development obligations.[20] El Paso's offer of equivalent payments for gas acquired under purchase contracts as for overrides on gas produced under the GLAs was an inducement to the lessees to shift development of their acreage to the pipeline. Each transaction made sense economically, only if undeveloped acreage were transferred, because El Paso was, in effect, trading on its status as a utility regulated on the "cost of service" basis.

(25) The GLAs were not the economic equivalents of gas sales contracts. The parties did not enter into the GLAs as a means of shifting payments as in *Rayne Field*. Rather, these agreements arose from the unique economic situation of the parties and reflected their efforts to structure the transactions so that El Paso would explore for and develop gas reserves in the Basin. The structuring of the economic risks and benefits between the parties more closely resembles the reallocation of risks and benefits in a farm-out than in a gas sales contract. The overall economic effect of the GLAs cannot be judged by merely looking to the ultimate purchaser of gas—the consumer—to see what price he pays. Were that reduction followed blindly, all gas transactions would be equivalent to gas sales contracts, since it is an irreducible economic fact that a consumer will pay for gas he uses.

(26) Plaintiff-Intervenor Pacific Northwest Pipeline Corporation (PNW) is a regulated interstate pipeline. PNW is successor in interest to certain El Paso properties.[21]

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[20] In GLAs 125 and 129 the lessee undertook the risk of development. (*See* Finding of Fact 20, *supra;* note 8, *supra*).

[21] *See United States* v. *El Paso Natural Gas Co.*, 358 F.Supp. 820 (D. Colo. 1972), *aff'd*, 410 U.S. 962, 93 S. Ct. 1440, 35 L.Ed.2d 697 (1973).

(27) Defendant Mobil Oil Corporation (Mobil) was originally a lessee of certain Basin properties located in Colorado. Mobil transferred these leases to PNW in an agreement denominated a Pacific Lease Agreement (PLA-13). PNW undertook a substantial drilling obligation when it signed PLA-13. At the time of transfer PLA-13 acreage was believed to be on the northernmost fringes of the Mesa Verde production area.

(28) PLA-13 is almost identical to the GLAs in issue here. PLA-13 differs in one significant respect from the GLAs. After the expiration of the initial term PLA-13 provides the amount of override is to be determined by a mechanical formula rather than by agreement or by arbitration.

(29) At the time PLA-13 was executed, no wells had been drilled on the acreage. A few wells had been drilled on adjacent acreage.

(30) The acreage conveyed by PLA-13 was not proven when PLA-13 was executed.

(31) The acreage conveyed by PLA-13 was not substantially developed when PLA-13 was executed.

(32) PLA-13 was not the equivalent of a gas sales contract.

(33) The gas produced from each of the agreements in issue traveled in interstate commerce.

CONCLUSIONS OF LAW

1. Because no agreement was the economic equivalent of a gas sale contract, and because the leases transferred were neither proven nor substantially developed at the time of the execution of those agreements, each agreement at issue in this litigation [GLAs 47, 52, 60, 61, 63, 66, 76, 78, 106, 125, 129, 172, 348, 349, and PLA-13] is not a "sale in interstate commerce of

natural gas for resale" within the meaning of Section 5 of the Natural Gas Act of 1938.[22]

2. No Defendant in this litigation is a "natural gas company" within the meaning of the Natural Gas Act because that Defendant claims an interest under an agreement in issue.[23]

3. The failure of each Defendant to seek certification from the FPC to collect overrides does not constitute a violation of the Natural Gas Act since no Defendant had a legal duty to seek such certification.[24]

4. Because the fact that leases transferred pursuant to GLA-125 were neither proven nor substantially developed was an ultimate adjudicatory fact necessarily decided in the *Webb-Turner* proceeding when El Paso sought to include its actual costs in its rates, because that fact was actually litigated by El Paso against the contentions of the Staff of the Federal Power Commission and the State of California, and because the *Webb-Turner* decision is now final, under the principle of collateral estoppel,[25] El Paso is precluded from relitigating the fact that

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[22] 15 U.S.C. § 717(b); *United Gas Improvement Co.* v. *Continental Oil Co.*, 381 U.S. 392, 85 S.Ct. 1517, 14 L.Ed.2d 466 (1965); *Federal Power Commission* v. *Pan American Petroleum Corp.*, 381 U.S. 762, 85 S.Ct. 1802, 14 L.Ed.2d 714 (1965); *Federal Power Commisson* v. *Panhandle Eastern Pipe Line Co.*, 337 U.S. 498, 69 S.Ct. 1251, 93 L.Ed. 1499 (1949); *Continental Oil Co.* v. *Federal Power Commission*, 370 F.2d 57 (5th Cir. 1966); *cert. denied*, 388 U.S. 910,87 S.Ct. 2114, 18 L.Ed.2d 1349 (1967); *Mobil Oil Corp.* v. *Federal Power Commission*, 149 U.S. App.D.C. 310, 463 F.2d 256 (1971), *cert. denied*, 406 U.S. 976, 92 S.Ct. 2409, 32 L.Ed.2d 676 *reh. denied*, 409 U.S. 903, 93 S.Ct. 103, 34 L.Ed.2d 166 (1972).

[23] 15 U.S.C.. § 717a(6).

[24] 15 U.S.C. § 717c(a), (c).

[25] *Blonder-Tongue Laboratories, Inc.* v. *University of Illinois Foundation*, 402 U.S. 313, 91 S.Ct. 1434, 28 L.Ed.2d 788 (1971); *Tampa Phosphate R. Co.* v. *Seaboard Coast Line R. Co.*, 418 F.2d

the GLA-125 leases were neither proven nor substantially developed.

5. This Court lacks jurisdiction over the subject matter because there has been no violation of the Natural Gas Act.[25]

6. This Court in its sound discretion declines to continue to exercise its pendent jurisdiction over the state contract claim still pending between PNW and Mobil. Although dismissal will cause some inconvenience to the litigants, to decide the claim would involve the Court in a determination of substantive Colorado law affecting real property located in Colorado. The interest that the State of Colorado has in deciding matters concerning real property located in Colorado, and the peculiar competency of Colorado State Courts to resolve such issues force this Court to conclude that to decide the issue would be an abuse of its discretion.[27]

The Court therefore ORDERS:

That this case be dismissed against all Defendants for want of jurisdiction.

That the costs be shared by all Plaintiffs and Intervenors equally.[28]

The Clerk is instructed to enter judgment.

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387 (5th Cir. 1969), *cert. denied*, 397 U.S. 910, 90 S.Ct. 907, 25 L.Ed.2d 90, *reh denied*, 397 U.S. 1030, 90 S.Ct. 1256, 25 L.Ed.2d 543 (1970).

[25] 15 U.S.C. § 717u.

[27] *See Moor* v. *County of Alameda*, 411 U.S. 693, 710, 93 S.Ct. 1785, 36 L.Ed.2d 596 (1973).

[28] 28 U.S.C. § 1919.

5. ORDER OF THE COURT OF APPEALS, *TENNECO OIL CO.* V. *FERC*, 580 F.2d 722 (September 6, 1978)

UNITED STATES COURT OF APPEALS
FIFTH CIRCUIT

Sept. 6, 1978

Nos. 77-2613, 77-2755, 77-2759, 77-2761, 77-2790, 77-2803, 77-2845, 77-2861 and 77-1762.

TENNECO OIL COMPANY and Continental Oil Company, *et al.*, *Petitioners*,

v.

FEDERAL ENERGY REGULATORY COMMISSION, *Respondent*.

EL PASO NATURAL GAS COMPANY, *et al.*, *Plaintiffs-Appellants*,

v.

SUN OIL COMPANY, *et al.*, *Defendants-Appellees*.

Natural gas producer to which certain working interests in oil and gas properties had been transferred under gas lease agreement brought action for declaratory judgment that owners of working interests transferred to producer were required to first seek certification from Federal Energy Regulatory Commission before collecting overriding royalties in excess of regulated interstate rates. The United States District Court for the Western District of Texas, Dorwin W. Suttle, J., 426 F.Supp. 963, dismissed action, and gas producer's appeal was consolidated with petitions for review of Commission's orders in related proceedings. The Court of Appeals held that it would withhold decision pending receipt of Commission's decision in related administrative proceeding which raised the same substantive question of whether natural gas lease-sale agreements were sales of gas in interstate commerce within meaning of Natural Gas Act.

Order accordingly.

Gordon Gooch, Washington, D.C., for Tenneco Oil Co., et al., Crown Central Petroleum, and Morris Mizel, et al.,

Leo J. Hoffman, Dallas, Tex., for Sun Oil Co. (Del.).

Robert D. Haworth, Houston, Tex., for Mobil Oil Corp.

W. B. Browder, Jr., Midland, Tex., for W. Watson LaForce, Jr., et al.

Sherman S. Poland, Washington, D.C., for William G. Webb, et al.

Michael J. Henke, Washington, D.C., for Union Oil Co. of Calif.

George B. Mickum, III, Washington, D.C., for Atlantic Richfield Co.

Steven A. Taube, Phillip R. Telleen, Federal Energy Regulatory Comm., Howard E. Shapiro, Sol., Washington, D.C., for Federal Energy Regulatory Comm.

John L. Williford, Bartlesville, Okl., for Phillips Petroleum Co.

J. O. Terrell Couch, Houston, Tex., for Robert Beamon, et al.

John S. Fick, Los Angeles, Cal., for Southern California Gas. Co.

Edwyn R. Sherwood, Colorado Springs, Colo., for Colorado Interstate Gas Co.

R. G. Thayer, Jr., Janice E. Kerr, San Francisco, Cal., for People of State of Cal. and Public Utilities Comm. of State of Cal.

Daniel Joseph, Jack W. Hanks, Washington, D.C., David K. Watkiss, Salt Lake City, Utah, for Northwest Pipeline Corp.

Shirley A. Woo, San Francisco, Cal., for Pacific Gas & Electric Co.

R. H. Landt, Denver, Colo., for Amoco Production Co.

Paul R. Connolly, Washington, D.C., for El Paso Natural Gas Co.

Petitions for Review of Orders of the Federal Energy Regulatory Commission.

Appeal from the United States District Court for the Western District of Texas.

Before BROWN, Chief Judge, and GODBOLD and RONEY, Circuit Judges.

ORDER:

These consolidated cases present an issue that is best handled by awaiting the action of the Federal Energy Regulatory Commission (FERC) in the related administrative proceeding raising essentially the same substantive question: Whether certain natural gas lease-sale agreements are sales of gas in interstate commerce within the meaning of § 5 of the Natural Gas Act, 15 U.S.C.A. § 717d. *See United Gas Improvement Co.* v. *Continental Oil Co. ("Rayne Field")*, 1965, 381 U.S. 392, 85 S.Ct. 1517, 14 L.Ed.2d 466; *Continental Oil Co.* v. *FPC ("Ship Shoal")*, 5 Cir., 1966, 370 F.2d 57, *cert. denied*, 1967, 388 U.S. 910, 87 S.Ct. 2114, 18 L.Ed.2d 1349.

Broadly stated, in the 1950's, Tenneco Oil, Sun Oil, Continental Oil, Atlantic Richfield, and several other oil companies entered into gas lease-sale agreements with El Paso Natural Gas Company in which they transferred to El Paso their working interests in certain leases in the San Juan Basin of New Mexico in return for the right to receive a so-called overriding royalty or payment. The royalty rate was to be redetermined after the initial term. If the parties could not agree on a new rate, it would be decided by arbitration.

In 1973, Sun Oil and El Paso failed to agree on a new override rate for their lease-sale agreement. A Board of Arbitrators awarded Sun Oil an override based on the wellhead price of intrastate gas instead of the regulated interstate gas rate. Other oil companies then sought to redetermine their royalty payments with El Paso.

El Paso brought four separate actions in the District Court for the District of Columbia, seeking a declaratory judgment that the royalty recipients were selling gas for resale in interstate commerce and that they had to seek certification from the Federal Power Commission (FPC) before collecting the claimed overriding royalties in excess of the regulated interstate rate.

The cases were consolidated and transferred to the Western District of Texas. On June 3, 1984, El Paso moved to refer the case to the FPC. The lower court carried the request with the case. After a lengthy trial, the District Court found that the lease-sale agreements were not economically equivalent to sales of gas in interstate commerce. The Court dismissed El Paso's complaint for lack of jurisdiction and effectively, although not explicitly, denied El Paso's motion for reference to FPC. *El Paso Natural Gas Co.* v. *Sun Oil et al.*, W.D.Tex., 1977, 426 F.Supp. 963.

El Paso appealed and on April 27, 1977, moved this Court to refer the appeal to the Commission. The motion was granted in a single judge order on August 4. This order, however, was vacated by this panel on January 8, 1978, and we heard oral argument on the merits of the case. *El Paso Natural Gas Co.* v. *Sun Oil et al.*, No. 77-1762 and the companion case (77-2613, *et seq.*).

When El Paso filed its motion for reference in the District Court on June 3, 1974, it also filed a complaint with the FPC to require the royalty interest owners in the San Juan Basin to show cause why they should not be directed to obtain certification of public convenience and necessity and to file rate schedules in accordance with those provisions. The FPC deferred action on the complaint pending the decision of the federal court in the Western District of Texas. On June 3, 1977, after the District Court's decision, the Commission issued an order instituting a show cause proceeding. The Commission denied a rehearing of its order on July 29.

In August 1977, Tenneco Oil, Atlantic Richfield, Sun Oil, and other companies filed petitions for review of the June 3 and July 29 orders of the Commission. *Tenneco Oil Co., et al.* v. *FERC*, Nos. 77-2613, *et al.* On September 12, 1977, and January 8, 1978, we denied their motions to stay the show cause proceeding. Hearings in the proceeding are now being held. The Commission has agreed, however, to bifurcate its proceeding so that a decision on the jurisdictional issue will be reached before the remedy question is decided.

Pursuant to this Court's January 8, 1978 order, we heard oral argument on the merits of appeal Nos. 77-2613, *et al.* along with appeal No. 77-1762. We now hold that the Court should have the full benefit of the opinion of the FERC (successor to the FPC) before deciding the appeal from the District Court. *J. M. Huber Corp.* v. *Denman*, 5 Cir., 1966, 367 F.2d 104; *Weymouth* v. *Colorado Interstate Gas Co.*, 5 Cir., 1966, 367 F.2d 84; *see Mississippi Power & Light Co.* v. *United Gas Pipe Line Co.*, 5 Cir., 1976, 532 F.2d 412, 418, *cert. denied*, 1977, 429 U.S. 1094, 97 S.Ct. 1109, 51 L.Ed.2d 541.

Accordingly, with respect to appeal from the District Court in No. 77-1762, the Court will withhold decision pending receipt of the opinion of the Commission in the proceedings involved in Nos. 77-2613, *et al.* We retain jurisdiction over both cases for the entry of whatever orders are necessary to assure that this matter is expeditiously considered by the FERC. If there is any indication of undue delay or the failure to act, the Court will take whatever proper action is reasonably necessary.

After the FERC reaches its decision concerning the gas lease-sale agreements and all petitions for rehearing have been considered, the Commission should file its orders, opinions, etc., with this Court for its consideration. The parties, without further leave, should then file briefs on what action this Court should take in either one or both of these proceedings now before us. The Court again admonishes counsel to avoid needless duplication.

6. ORDER OF COURT OF APPEALS, *TENNECO OIL CO.* V. *FERC* (OCTOBER 25, 1978)

FOR THE FIFTH CIRCUIT

Nos. 77-2613, *et al.*
(No. 77-2845)

TENNECO OIL COMPANY, *ET AL.*,
(WILLIAM G. WEBB, *ET AL.*)
Petitioners,

v.

FEDERAL ENERGY REGULATORY COMMISSION,
Respondent.

On Petitions For Review Of Orders Of The Federal Energy Regulatory Commission (Texas Cases)

No. 77-1762

EL PASO NATURAL GAS COMPANY, *ET AL.*,
Plaintiffs-Appellants,

v.

SUN OIL COMPANY, *ET AL.*,
Defendants-Appellees.

Oct 25 '78
Edward W. Wadsworth
Clerk

Appeal From The United States District Court For The Western District Of Texas

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Before BROWN, Chief Judge, GODBOLD and RONEY, Circuit Judges

BY THE COURT:

In connection with the motion of William G. Webb for clarification, the Court states that since William G. Webb was not a party to the District Court proceedings, the order of this Court with respect to that proceeding will not have any effect as to William G. Webb as a party; however, William G. Webb is very much a party to the proceedings pending before the Federal Energy Regulatory Commission and will, along with all other parties to that proceeding, be affected and bound by the action of the Commission and, on appeal or review by this Court, by the orders of this Court.

7. JUDGMENT OF THE COURT OF APPEALS, *TENNECO OIL CO.* V. *FERC*, NO. 80-2404 (JULY 5, 1983)

UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT*

No. 80-2404

FERC Nos. CP74-314, CP76-327, and CI77-526

TENNECO OIL COMPANY, *ET AL.*,
Petitioners,

v.

FEDERAL ENERGY REGULATORY COMMISSION,
Respondents.

Petitions For Review Of Orders Of The Federal Energy Regulatory Commission

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Before BROWN, RONEY and TJOFLAT, Circuit Judges.

JUDGMENT

These causes came on to be heard on the petitions of Tenneco Oil Company, et al., for review of orders of the Federal Energy Regulatory Commission, and were argued by counsel;

ON CONSIDERATION WHEREOF, It is now ordered and adjudged by this Court that the orders of the Federal Energy Regulatory Commission in these causes be, and the same are hereby, reversed;

IT IS FURTHER ORDERED that intervenors-respondents pay to petitioners, the costs on appeal to be taxed by the Clerk of this Court.

July 5, 1983

ISSUED AS MANDATE: DEC 14 1983

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*Former Fifth Circuit case, Section 9(1) of Public Law 96-452-October 14, 1980.

8. JUDGMENT OF THE COURT OF APPEALS, *TENNECO OIL CO.* V. *FERC*, NO. 77-2613 (JULY 5, 1983)

UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT*

No. 77-2613

FERC Nos. CP74-314, et al.

TENNECO OIL COMPANY, *ET AL.*,
Petitioners,

v.

FEDERAL ENERGY REGULATORY COMMISSION,
Respondents.

Petitions For Review Of Orders Of
The Federal Energy Regulatory Commission

Before BROWN, RONEY and TJOFLAT, Circuit Judges.

JUDGMENT

These causes came on to be heard on the petitions of Tenneco Oil Company, et al., for review of orders of the Federal Energy Regulatory Commission, and were argued by counsel;

ON CONSIDERATION WHEREOF, It is now ordered and adjudged by this Court that the orders of the Federal Energy Regulatory Commission in these causes be, and the same are hereby, dismissed;

IT IS FURTHER ORDERED that intervenors-respondents pay to petitioners, the costs on appeal to be taxed by the Clerk of this Court.

July 5, 1983

ISSUED AS MANDATE: DEC 14 1983

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*Former Fifth Circuit case, Section 9(1) of Public Law 96-452-October 14, 1980.

9. JUDGMENT OF THE COURT OF APPEALS, *EL PASO NATURAL GAS CO.* V. *SUN OIL COMPANY*, NO. 77-1762 (JULY 5, 1983)

UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT*

No. 77-1762

D.C. Docket No. MO-74-CA-57

EL PASO NATURAL GAS COMPANY, *ET AL.*,
Plaintiffs-Appellants,

v.

SUN OIL COMPANY, *ET AL.*,
Defendants-Appellees.

Appeals From The United States District Court For The Western District Of Texas

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Before BROWN, RONEY and TJOFLAT, Circuit Judges.

JUDGMENT

This cause came on to be heard on the record on appeal and was argued by counsel;

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court that the judgment of the said District Court in this cause be, and the same is hereby, affirmed;

IT IS FURTHER ORDERED that plaintiffs-appellants pay to defendants-appellees, the costs on appeal to be taxed by the Clerk of this Court.

July 5, 1983

ISSUED AS MANDATE: DEC 14 1983

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*Former Fifth Circuit case, Section 9(3) of Public Law 96-452-October 14, 1980.

10. ORDER OF THE COURT OF APPEALS DENYING PETITION FOR REHEARING AND SUGGESTION FOR REHEARING EN BANC (DECEMBER 2, 1983)

IN THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT*

NOS. 77-1762, 77-2613 and 80-2404

EL PASO NATURAL GAS COMPANY, *et al.*,
Plaintiffs-Appellants,

v.

SUN OIL COMPANY, *et al.*,
Defendants-Appellees.

TENNECO OIL CO, *et al.*, *Petitioners,*

v.

FEDERAL ENERGY REGULATORY COMMISSION,
Respondent.

TENNECO OIL COMPANY, *et al.*,
Petitioners

v.

FEDERAL ENERGY REGULATORY, COMMISSION,
Respondent.

Nos. 77-1762, 77-2613 and 80-2404.

**Appeal From The United States District Court
For The Western District Of Texas**

**Petitions For Review Of Orders Of The
Federal Energy Regulatory Commission**

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*Former Fifth Circuit case, Section 9(1) of Public Law 96-452-October 14, 1980.

U.S. COURT OF APPEALS
FILED
DEC 2 1983
Gilbert F. Ganucheau
Clerk

ON PETITION FOR REHEARING AND SUGGESTION FOR REHEARING EN BANC

(Opinion July 5, 5 Cir., 1983, 708 F.2d 1011).

(December 2, 1983)

Before BROWN, RONEY and TJOFLAT, Circuit Judges.

PER CURIAM:

(√) The Petitions for Rehearing Are DENIED and no member of this panel nor Judge of this Administrative Unit in regular active service having requested that the Court be polled on rehearing en banc (Rule 35, Federal Rules of Appellate Procedure; Local Fifth Circuit Rule 16; Fifth Circuit Judicial Council Resolution of January 14, 1981), the suggestions for Rehearing En Banc are DENIED.

ENTERED FOR THE COURT:

Paul H. Roney
PAUL H. RONEY
United States Circuit Judge

11. ORDER OF THE FEDERAL ENERGY REGULATORY COMMISSION DENYING APPLICATIONS FOR REHEARING, *EL PASO NATURAL GAS CO.*, 13 FERC ¶ 61,239 (DECEMBER 18, 1980)

13 FERC ¶ 61,239

El Paso Natural Gas Company, Docket No. CP74-314; Northwest Pipeline Corporation, Docket No. CP76-327; Sun Oil Company, et al., Docket No. CP77-526

Order Denying Applications for Rehearing

(Issued December 18, 1980)

Before Commissioners: Georgiana Sheldon, Acting Chairman; Matthew Holden, Jr., George R. Hall and J. David Hughes.

On October 24, 1980, a number of producer-respondents[1] filed applications seeking rehearing of the Commission's order issued in the above-captioned proceeding on September 25, 1980. Upon review, the Commission finds the applications for rehearing disclose no new facts or principles of law which would warrant modification of the September 25 order. Rehearing shall therefore be denied.

On October 16, 1980, the Commission staff filed a motion concerning the remedy phase of this proceeding. In the order of September 25, the Commission ordered that a hearing be held to determine proper remedies for past and future periods in light of the Commission's determination in the September 25 order that it had jurisdiction over the lease-sale agreements at issue in this proceeding. In its October 16 motion, the staff questions whether the Commission intended the remedy phase

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[1] Tenneco Oil Company, Contintental Oil Company, American Petrofina Company of Texas, Crown Central Petroleum Corporation, Delta Drilling Company, Mr. and Mrs. Morris Mizel, Union Oil Company of California, Atlantic Richfield Company, Sun Oil Company (Delaware), F.H.N., Ltd., W. Watson LaForce, Jr., Robert Beamon, Individually and as Trustee, Thomas L. Hail, Trustee, Pattie Ann Beamon Lundell, William G. Webb, Phillips Petroleum Company, Getty Oil Company, Amoco Production Company, and Mobil Oil Corporation.

to begin immediately. The staff argues that the remedy-phase hearing should begin immediately and requests the Commission to so order.

Upon review of this matter, we find no need to act on the staff's motion. There is no intent whatsoever on the Commission's part to delay the remedy-phase hearing. We do not believe the order of September 25 can reasonably be interpreted as suggesting or authorizing any delay in convening the further hearing. We believe the scheduling of the hearing should be left to the discretion and judgment of the presiding judge. We think it was clearly reasonable for the judge to defer scheduling the hearing while the applications for rehearing of the September 25 order were pending.

The Commission orders:

The applications for rehearing of the order of September 25, 1980, are denied.

12. NATURAL GAS ACT, §§ 1(b), 2(6), 4(a), 7(c)

Section 1(b), 15 U.S.C. § 717(b), provides in full:

The provisions of this act shall apply to the transportation of natural gas in interstate commerce, to the sale in interstate commerce of natural gas for resale for ultimate public consumption for domestic, commercial, industrial, or any other use, and to natural gas companies engaged in such transportation or sale, but shall not apply to any other transportation or sale of natural gas or to the local distribution of natural gas or to the facilities used for such distribution or to the production or gathering of natural gas.

Section 2(6), 15 U.S.C. § 717a(6), provides in full:

(6) "Natural-gas company" means a person engaged in the transportation of natural gas in interstate commerce, or the sale in interstate commerce of such gas for resale.

Section 4(a), 15 U.S.C. § 717c(a), provides in full:

All rates and charges made, demanded, or received by any natural-gas company for or in connection with the transportation or sale of natural gas subject to the jurisdiction of the Commission, and all rules and regulations affecting or pertaining to such rates or charges, shall be just and reasonable, and any such rate or charge that is not just and reasonable is hereby declared to be unlawful.

Section 7(c), 15 U.S.C. § 717f(c), provides in part:

No natural-gas company or person which will be a natural-gas company upon completion of any proposed construction or extension shall engage in the transportation or sale of natural gas, subject to the jurisdiction of the Commission, or undertake the construction or extension of any facilities therefor, or acquire or operate any such facilities or extensions thereof, unless there is in force with respect to such natural-gas company a certificate of public convenience and necessity issued by the Commission authorizing such acts or operations.